COLLEGE
OUTLINE
SERIES

$1.95

NO. 40

BUSINESS LAW

by HUGH W. BABB
CHARLES MARTIN

COMMON LAW
CONTRACTS
SALES
AGENCY
NEGOTIABLE INSTRUMENTS
PARTNERSHIP
CORPORATIONS
SECURITY
BANKRUPTCY

.EYED TO STANDARD TEXTBOOKS

EVIEW FOR CPA AND OTHER EXAMINATIONS

The Authors

HUGH W. BABB received his B.A. from Oxford University and his LL.B. from Harvard University. Professor and Head of the Department of Law, Boston University, a member of the Massachusetts Bar, and Honorary President of the American Business Law Association, he is also the author of *Negotiable Instruments: Cases and Materials.*

CHARLES MARTIN received his B.A. from the College of the City of New York and his J.D. and J.S.D. from New York University. Professor of Law at the College of the City of New York and a member of the New York and Florida Bar, he is co-author of *The Law of Negotiable Instruments* and *Materials in the Law of Mercantile Transactions* and author of *The Law of Mercantile Transactions* and of articles which have been published in various law reviews. He belongs to Theta Sigma Lambda and the American Business Law Association.

COLLEGE OUTLINE SERIES

BUSINESS LAW

REVISED EDITION

By Hugh W. Babb, LL.B.
Charles Martin, J.S.D.

BARNES & NOBLE, INC. • NEW YORK

PUBLISHERS • BOOKSELLERS • FOUNDED 1873

Reprinted, 1958

L. C. Catalogue Card Number: 52-2217

Printed in the United States of America

Preface

This outline is intended to serve both as a comprehensive review of business law and as a text. Not merely principles, but their rationale and historical development are set forth. Abstract rules are extensively but concisely illustrated by means of actual cases boiled down to their quintessence.

The student preparing for C. P. A., Civil Service, or other examinations of which business law problems form an important part, will find what he needs here. Refinements of principle have been relegated to small type, a matter of some convenience when a quick review is desired. At the same time their inclusion broadens the scope of the book's usefulness as a ready reference manual for accountants and businessmen.

The outline comprises History and Development of Common Law, Contracts, Sales, Agency, Negotiable Instruments, Partnership, Corporations, Security, Bankruptcy, Government Regulation of Business, and War and Emergency Powers of the President. The treatment of government regulation of business is in proportion to the ever increasing importance of the subject, and those engaged in governmental or administrative work will find many Supreme Court decisions and much statutory material brought within a narrow compass.

H. W. B.
C. M.

Table of Contents

PART I

COMMON LAW AND ITS DEVELOPMENT

PART II

CONTRACTS

PART III

SALES

PART IV

AGENCY

PART V

NEGOTIABLE INSTRUMENTS

PART VI

PARTNERSHIP

PART VII

CORPORATIONS

PART VIII

SECURITY DEVICES

PART IX

BANKRUPTCY

PART X

GOVERNMENT REGULATION OF BUSINESS

TABULATED BIBLIOGRAPHY OF STANDARD TEXTBOOKS

The following list gives the author, title, publisher, and date of the standard textbooks referred to in the tables on the two succeeding pages.

Anderson, Ronald A. *Cases on Business Law*, South-Western, 1953.

Anderson, Ronald A., and Kumpf, Walter A. *Business Law*, 5th ed., South-Western, 1956.

Charles, A. A. *College Law*, 5th ed., South-Western, 1957.

Conyngton, T. and Bergh, L. O. *Business Law*, 5th ed., Ronald 1956.

Dillavou, Essel R. and Howard, Charles G. *Principles of Business Law*, 6th ed., Prentice-Hall, 1957.

Dykstra, G. O. and Dykstra, L. G. 2nd ed., *Business Law*, Pitman, 1958.

Frascona, Joseph L. *Business Law*, 1st ed., Irwin, 1954.

Hicks, Clifford M. *Business Law*, Harper, 1952.

Lavine, A. L. *Modern Business Law*, Prentice-Hall, 1954.

Lavine, A. L. and Edelson, E. M., rev. ed., *College Business Law*, Rev. Rowe, 1958.

Lusk, H. F. *Business Law*, 5th ed., Irwin, 1955.

Rosenberg, Robert R. *College Business Law*, Gregg, 1953.

Schrampfer, W. H. *Law in Its Application to Business*, 2nd ed., Farrar & Rinehart, 1952.

Spencer, William H. and Gillam, Cornelius W. *A Textbook of Law and Business*, 3rd ed., McGraw-Hill, 1952.

——— *A Casebook of Law and Business*, 2nd ed., McGraw-Hill, 1953.

Stone, R. E., et al. *Fundamentals of Business Law*, Foundation, 1950.

Teevan, J. C. and Smith, L. Y. *Business Law, Cases, Text, Statutes*, West, 1952.

Wyatt, J. W. and Wyatt, M. B., *Business Law*, McGraw-Hill, 1958.

QUICK REFERENCE TABLE TO STANDARD TEXTBOOKS

All figures refer to pages

PART IN BUSINESS LAW	TOPIC	ANDERSON	ANDERSON & KUMPF	CHARLES	CONYNGTON & BERGH	DILLAVOU & HOWARD	DYKSTRA & DYKSTRA	FRASCONA	HICKS	LAVINE (Mod. Bus. Law)
I	COMMON LAW AND ITS DEVELOPMENT	1-28	1-24	3-20	3-28	1-27	1-10	3-79	1-16	3-32
II	CONTRACTS	29-162	25-150	23-112	29-166 231-238	29-219	11-311	83-219	17-280	33-134
III	SALES	483-566	433-504	115-156	375-438 451-463	674-708	772-857 662-663	281-404	281-400	226-263
IV	AGENCY	163-208	151-192	273-326	167-220	221-283	312-420	223-278	401-516	387-942
V	NEGOTIABLE INSTRUMENTS	269-354	245-324	197-270	481-549	285-471	858-983	407-504	517-632	135-225
VI	PARTNERSHIP	651-712	585-638	329-360	249-304	475-533	421-486	573-635	783-847	458-493
VII	CORPORATIONS	713-798	639-710	363-398	305-374	534-644	487-656	639-684	848-1000	494-568
VIII	SECURITY DEVICES	405-430 633-650	347-388 565-584 759-790	437-448 138-141	550-562 576-611 621-638	727-796	741-751	507-569	1022-1026	264-281 332-349 683-703
IX	BANKRUPTCY	1001-1026	873-896	507-518	761-798	191-202		691-711	1056-1082	704-747
X	GOVERNMENT REGULATION OF BUSINESS	1065-1078		381-383 76-78	439-450 464-480 799-846	881-905 927-974				430-457 569-613

PART IN BUSINESS LAW	TOPIC	LAVINE & EDELSON	LUSK	ROSEN-BERG	SCHRAM-PFER Applications	SPENCER Textbook	SPENCER Casebook	STONE et al.	TEEVAN & SMITH	WYATT & WYATT
I	COMMON LAW AND ITS DEVELOPMENT	1-9	1-31	4-26	3-22	3-183 786-798	1-38	1-221	1-23	3-13
II	CONTRACTS	16-152	49-310	27-164	24-240	184-308	181-334	222-498	24-212	23-164
III	SALES	243-302	693-775	165-205	157 281-300	483-537	678-754	499-708	323-412	370-436
IV	AGENCY	403-456	311-403	347-374	399-497	309-347	335-392	758-830	213-278	167-225
V	NEGOTIABLE INSTRUMENTS	153-242	776-913	233-300	507-642	642-703	762-878	1129-1162	413-558	237-350
VI	PARTNERSHIP	457-499	404-468	376-394	703-787	967-1093	393-470	831-931	559-620	609-669
VII	CORPORATIONS	500-537	469-595	395-415	791-880	967-1093	471-638	932-1128	622-709	670-760
VIII	SECURITY DEVICES	291-298 320-323	651-692	301-313 185-189	325-352 673-700	705-777	755-761	44, 101 185-189 418-420 566-576 631-637	875-901 944-952	538-576
IX	BANKRUPTCY	595-603	945-965	156-164	883-913	801-825		377, 417 437, 494 497, 753 892, 902	953-966	597-606
X	GOVERNMENT REGULATION OF BUSINESS			450-479	178	537-637		35, 36 189-191 1172-1184		763-776

See page xi for list of complete titles.

Part I: Common Law and Its Development

CHAPTER I

COURTS AND REMEDIES

There has been much philosophizing about the nature of law, particularly on the continent of Europe. The realistic view prevailing in Anglo-American jurisprudence emphasizes the dominant part of the courts in the declaration and administration of law and sees the law as the apparatus (the aggregate body of rules recognized by the community as binding and enforced by the courts), whereby (with absolute equality, in theory) they actually determine legal rights and duties in pending controversies. Law is therefore classified as a social science. It is a living phenomenon having a real existence in relation to the facts of human affairs. Its evolution has been profoundly affected by the fact that (particularly in earlier times) its development depended on the chance circumstances of particular cases happening to come before the courts.[1] Wrongs, originally seen as *crimes* (to be atoned for or punished), came to be seen also as *torts*[2] (giving rise to a right of compensation), and through this concept of *delictual* obligation the courts later worked out the *consensual* obligations of contracts not under seal.

THE DEVELOPMENT OF THE ENGLISH COURTS

For most practical purposes, it has been said, history of English law does not begin until after the Norman Conquest (1066). Central authority in Europe had collapsed.

1 This is true both of *substantive law* (declaring and defining rights and duties) and of *adjective law* (practice, pleading, evidence, judgment, and execution concerned with the procedure for the effectuation of rights and duties in the courts).

2 A *tort* is a civil injury to a legally protected interest (other than a breach of contract) remediable in a common law action for damages. In tort D's (the defendant's) duty is created by law, whereas in contract it is consensual (created by mutual consent).

Society was assumed to be normally at war and accordingly to be organized on the basis of the decentralized militarism whose foundation was land tenures — *feudalism.* The lord was bound to protect his man and to respect certain property rights of the latter, and the man was subject to the jurisdiction of the lord's court and owed the lord fealty, counsel, and services. The exceedingly high degree of administrative efficiency attained by the Normans in the hundred years before 1066 (particularly as to financial organization) was, after the Conquest, directed upon governmental affairs in England. Within four centuries thereafter the "king's courts" had emerged. First, from the Exchequer (where sheriffs had made accounts) came the Exchequer of Pleas (originally where accounts were settled), which by the end of the twelfth century was deciding cases of all sorts (bearing no necessary relation to revenue) and which (after a movement in the next century toward restricting its authority to finance) greatly extended its jurisdiction by allowing the plaintiff (P) to allege the fiction (which D, the defendant, was not allowed to traverse) that D's failure to pay P left P in turn unable to pay the king, wherefore the Exchequer (until 1832) would issue a writ against D.[3] In 1178 a new central court was created with civil jurisdiction and expressly subject to the supervision of the Council. It later became the Court of Common Pleas, with exclusive jurisdiction over real actions (until the evolution of another fiction in the seventeenth century). Out of the political and administrative activities of the Council came in the thirteenth century a third court (the King's Bench), which heard Pleas of the Crown (criminal cases in which the Crown had a particular interest) and appeals from Common Pleas, issued "prerogative" writs, and sought by fictions[4] to extend its jurisdiction (original and appellate). By the fourteenth century the judges, who at first (during the twelfth and thirteenth centuries) had acted with fairly broad discretion, became far more narrow and tech-

3 This was the *quominus* writ (*Quominus Sufficiens Existit*).

4 Such as the *Bill of Middlesex,* alleging that D, having committed a (fictitious) trespass *"latitat et discurrit"* and adding a clause (*ac etiam*: and moreover) which set out the real clause of action.

nical in this regard. By this time various circumstances were operating to bring cases to the king's courts rather than to the local or other courts — their issuance of writs (*de recto tenendo*) ordering the lord to do justice in his court to the petitioner, who otherwise would be heard in the king's court (from the second half of the twelfth century on, such a writ is thought to have been essential in an action for freehold; moreover in such action the tenant could refuse "trial by battle" and put himself on the more desirable "grand assize" of twelve sworn neighbors), their protection of one in possession of land claiming a freehold (from about the same period) at the expense of the disseisee's right of self-help, and their recognition of torts (beginning with trespass in the thirteenth century). In the meantime, the ecclesiastical courts (administering the canon law) were excellently organized and asserted an extensive jurisdiction including authority over ecclesiastical status and persons, matrimonial relations, and testamentary causes (testacy and intestacy). Until the Reformation their court of last resort was the Papal Curia at Rome. They then became royal courts, from which there was right of appeal to the Court of Delegates (from 1832 to the Privy Council). In 1857 their civil jurisdiction over matrimonial and probate cases was transferred to the Probate, Divorce, and Admiralty Division of the High Court.

The use of writs (executive orders — not in the first instance necessarily connected with litigation — issued by the king and sealed with his seal, ordering the sheriff to bring or to summon D) increased very greatly with the extension of royal power after the Conquest. Without an originating writ neither an action in the king's courts nor (since the early thirteenth century) an action anywhere concerning freehold, could be begun; and writs were, by the twelfth century, in familiar and increasing use as the recognized mode of starting extraordinary suits in the royal courts. The evolution of our substantive law was chiefly the history of the development of remedies in terms of writs and procedural forms, each "procedural pigeonhole" having its own rules of substantive law. At the head of the bureau which

issued writs (routine or special) was the *chancellor,* who became a great political personage, custodian of the great seal. Probably as a matter of convenience, the Council delegated to him, with his trained secretariat, petitions for extraordinary advice and relief where at common law a remedy was either lacking or unavailing. Thus from the fourteenth century on the chancellor came to give (in his discretion) an effectual remedy (simpler and quicker, far more flexible and unconstrained by precedent for more than three centuries) as *"equity and good conscience"* seemed to him to define the duties of the respondent (as in the case of a trust, held binding since the fifteenth century). While chancery never claimed to be superior to courts of law, it did assume to issue personal directions to a party before it and thus to require such a party not to go to law, whereas the law courts could not forbid a party to invoke the aid of chancery. In 1616 the Chancellor (Lord Ellesmere) thus enjoined (forbade) the enforcement by D of a common law judgment (against P) obtained by highly improper means, whereupon the Chief Justice (Coke) caused P to be indicted. James I, far from reluctant to appear supreme over all his judges and all his courts, exercised the royal prerogative in favor of chancery on the basis of a strong current of practice since the fifteenth century, and its jurisdiction continued and is still an integral part of judicial administration.

From the custom of the king's court as the common law of the land three classes of persons — priests, merchants, and Jews — were more or less exempt. Although commerce was not yet the normal occupation of the nation, merchants, to whom the expeditious and nontechnical handling of their legal affairs was more important than anything else, had the privilege of resorting to local courts such as borough courts, fair courts, and staple courts, held under crown grant. Few mercantile cases came to the royal courts; and while it is impossible to be dogmatic (since the records of the local courts have been destroyed, whereas reports of law cases go back to Edward I and of chancery cases to Elizabeth, though the aggregate down to Charles II is small), it is

generally held that from the thirteenth century in maritime and commercial cases the mercantile courts applied a body of mercantile law (with slight, local variations) internationally recognized in the trade of western Europe and the law of the sea [5] and supposed to be founded on the law of nature — the law merchant, from which developed the rules of bills and notes, sales of goods, partnerships, guaranty, insurance, and agency. By reason of the waning importance of the fair courts (as trade became localized in the cities) and, perhaps, of the inefficiency of the other local courts, the judicial power of admirals developed into the jurisdiction of the Court of Admiralty (originally confined to cases starting outside England), which was "ruled by equity and marine law" and whose regular records, beginning under Henry VIII, disclose dealings with maritime and commercial contracts (such as bills and notes, bills of lading, and policies of insurance) long before they were known to the common law courts. Its jurisdiction became so extensive as to attract the attention of the common law courts, [6] which in the sixteenth century proceeded to extend their jurisdiction at the expense of that of the Lord High Admiral, permitting (nontraversable) fictions that a contract was made in Bordeaux "in Cheapside" and issuing writs of prohibition to his court as to an "inferior Court"; and by the seventeenth century admiralty authority had shrunk to little more than jurisdiction over contracts made and performable, and torts committed, on the high seas, while in the same period the king's courts were allowing assumpsit on a bill of exchange (1602) and permitting nonmerchants to become parties thereto (1690). In mercantile controversies thus required to be brought to the king's courts, mercantile customs were gradually recognized as part of the general law of the land, so that by 1765 Lord Mansfield (Chief Justice of the King's Bench, 1756-1788) could say that the law of merchants and the law of the land were the same.

---

5 Such as the Byzantine codification of Rhodian Sea Law (tenth century), the sea Codes of Oleron (twelfth century), Barcelona (The Consulate of the Sea: fourteenth century), and Wisby.

6 These had now developed the remedy of *assumpsit*.

FORMS OF ACTION

Before 1066 wrongs of violence were matters to be avenged by the injured party and his kindred. Then, as an alternative to the "feud," the community encouraged the giving and acceptance of compensation in place of the surrender of the offending person or thing or retaliation to the point of inflicting equal harm. When feudalism came in, the king sought to protect a general or special peace — not without a view to sharing the proceeds. Then such wrongs became felonies. The crown set up machinery to discover crimes and itself created new ones. By the middle of the thirteenth century the jurisdiction of the king's courts over felonies and over many civil wrongs was clear.

In the empirical evolution of our substantive law, remedial forms of action — and particularly the system of writs — played for centuries a part of paramount importance. Social interest in the safeguarding of acquisitions was still dominant — the criminal law protecting the landowner from violence and the common law securing him in possession. The emphasis was on *possession* (intent to control effectively and exclusively, implemented by actual or constructive power so to control) rather than on *ownership* (the entirety of powers of use and disposal allowed by law). Property rights were rights to resist invasion of possession. The more important wrongs were conceived in terms of property. By the end of the twelfth century the disseisee (except for an extremely brief right of self-help) was compelled to invoke the possessory assize of the royal court. Trespass was the deliberate and violent breach of the king's peace by forcible invasion of possession. Writs of trespass had so developed as to be writs issuing "as of course" in the thirteenth century, the "quare" action (*quare clausum fregit*) for damage to property being used to sue for damages (rather than vengeance) though entailing as well payment of a fine to the king for breach of the peace, and ordinarily containing no felony charge, and the procedure being half criminal, half civil. In addition to familiar types of *trespass* by direct physical act (carrying off P's goods,

invading P's possession of land and doing damage, or forcible aggression against P or his property) there developed the use in the king's courts of writs framed to meet unclassified situations (not involving physical force and previously dealt with in the local courts) which came to constitute the action of "case," where the damage was caused either by means less personal than in trespass or by omission to act.[7] "Case" was extended by fictions to many actions of malfeasance and misfeasance, but always to wrongs with special names and their variants — a wrong of assault, a wrong of battery, a wrong of conspiracy, a wrong of conversion, a wrong of deceit, a wrong of libel or slander, a wrong of negligence, a wrong of nuisance, a wrong of trespass. There is no generic concept of one province of civil wrongs (neither breach of contract nor breach of trust) with liability rested either on intent (when the function of law was supposed to be the effectuation of the utmost liberty of the individual) or on a social interest in the general security.

For a long time, neither the ecclesiastical recognition of the validity of agreements regardless of form nor the recognition (on the continent) of mercantile practice made headway against the procedural system in the king's courts, which (in the times of Edward I to Edward III) as to consensual obligations recognized only:

1. Proprietary actions of debt, either on formal obligations under seal specifying a sum certain, or on "real" contracts (on executed consideration) for the specific restoration of a thing or a liquidated amount received by D and belonging to P;

2. Actions of covenant on a sealed acknowledgment of obligation;

3. Actions of account (upon a relational obligation in favor of lord or principal against bailiff or factor); and

4. Actions of replevin (originating in an action in the

7 The wrong of detaining P's chattels was also recognized at an early time, but rather as an offshoot of the ancient action of debt (as on a deed or for rent, price, or statutory penalties).

sheriff's courts by the owner of chattels allegedly distrained illegally by lord or lessor).

By the time of Edward III one type of the increasing actions "on the case" was *assumpsit,* where D (a surgeon, smith, barber, carpenter, or bailee, or one assuming the duties of a public calling) *"undertook"* to produce a specific result or to do something skilfully, and was held liable by P, suing in "case," for the harm directly resulting from his misfeasance (whether the basis of recovery was trespass or deceit was not always clear). Thus (in 1348) D "undertook" to carry P's mare in D's boat safe across the River Humber, whereas he overloaded the boat and the mare was drowned: P apparently sued on an assumpsit, and the King's Bench intimated that the overloading was a tort (trespass). A century later it was held deceitful for D (employed by P to buy a manor for P, or paid by P for his promise to convey land to P) to buy for or convey to A. Although it is harder to see failure to act as a trespass, failure to build a mill as agreed was held actionable (1424) and in the time of Henry VII assumpsit was held to lie for *nonfeasance* where D (having already received the *quid pro quo*) failed to perform the agreed exchange (whether act or promise) by reliance whereon P was damaged. Finally in 1602 it was held that "every contract executory imports in itself an assumpsit," so that the precedent "occasion" or *causa* (the "consideration," in modern terminology) essential to support D's promise might be an earlier debt, an act or promise as "present consideration," or a detriment to the promisee requested by the promisor. D was therefore liable:

1. Where, having "assumed" to act, and having induced P to change his position by entrusting to D his person or property, D was treated as having committed a tort if he injured it carelessly or wholly failed to do what he had agreed; or

2. Where D's later promise rested on a benefit previously received by him and constituting an earlier debt.

In addition to express and implied contracts (whose obli-

gation is consensual) there are *restitutional* duties imposed by law upon D *quasi ex contractu* to prevent his being unjustly enriched at P's expense, irrespective of any explicit intent or promise manifested by D, and although the parties are unable or unwilling to agree. For a time P was obliged to resort to chancery for recognition and enforcement of obligations thus *implied in law*, but after the gradual extension of "case" it was not much of a step to *"indebitatus assumpsit"* — *"quantum meruit," "quantum valebant,"* "moneys had and received," and "money paid"—to recover damages to the full amount of the debt (not the debt itself), and Lord Mansfield turned from the concept of a fictitious contract to "ties of natural justice and equity" and *"ex aequo et bono"* as indicating the basis of recovery.

PROPERTY

Although there had been an infiltration of feudalism into England before 1066, the completeness of the Norman Conquest made possible its unprecedentedly speedy and complete development in England. Within twenty years, a detailed survey of resources (the Domesday Book) was prepared. *Heritable estates* in land were recognized by Henry I as to tenants holding directly of him, and within a century or so became an ordinary incident of a "fee." We have seen how the protection of seisin was deemed incidental to the extension of the king's peace under Henry II (there could be no disseisin without a judgment and only the king's courts had jurisdiction over controversies about possession of land). Alienation of estates in land (first, perhaps, to the Church) was, after various attempts to prevent it, free, the assent of the lord being unnecessary after 1290.

CHAPTER II

THE SOURCES OF LAW AND JURISDICTION

THE SOURCES OF LAW

(a) *The Common Law* consists of principles based on immemorial custom and enforced by the courts (in the absence of applicable statute). It is traditionary, *unwritten* law (not declared by a body having legislative authority), of Germanic origin, developed in the English courts during the period beginning with the thirteenth century and extending into the eighteenth, and brought to this country by the colonists (whose common law was made up of English common law and English statutes then existing — with such exceptions as different conditions here required — together with local legislation modifying the common law and local usages adopted in a given colony by general consent). The common law is thus a system of elementary principles and general juridic truths, resting for authority upon common recognition, consent, and use, evidenced by court decisions, continuously expanding with the progress of society, and adapting itself to the exigencies and usages of the country and to commerce and the mechanical arts. It fills the gap filled on the continent of Europe by Roman law. There is no common law of the United States, but rather a separate system of common law in each of the 48 states. Common law is affected, though not dominated, by precedent—until the end of the thirteenth century the judicial function was to evaluate, rather than to follow slavishly, the general and immemorial customs of England. Then, from the persuasive authority of analogous decisions (whose very number might evidence long-established, and therefore controlling, custom) the system of *stare decisis* (adherence to precedent) developed gradually to the period of its greatest

influence in the last part of the eighteenth century. Decisions are cited as early as the beginning of the twelfth century to prove what a given custom is and the record of proceedings in the king's courts goes back to the end of that century, while the yearbooks, compiled apparently to furnish precedents for the judges, begin about a century later (1284). The influence of precedents (whether "squarely in point" or applicable by analogy) is now much qualified in practical application — especially since courts do not hesitate to avail themselves of nonlegal materials. The American Law Institute (organized in 1923 and largely supported by the Carnegie Corporation), whose membership of about seven hundred includes justices of the Supreme Court of the United States, senior judges of the federal Circuit Court of Appeals, chief justices of a number of states, certain officers of bar associations, and deans of a number of law schools, was formed to prepare an orderly restatement of the common law in the interests of clarification, simplification, and certainty. It has adopted and promulgated a number of such restatements, of which the first was the Restatement of the Law of Contracts (1932).

(b) *Equity.* The development of Chancery jurisdiction in England has been considered already. In this country there are six states, including New Jersey, which have separate courts in equity. In most states, however, there are no separate equity judges specifically appointed as such; and equitable rights or defenses are there adjudicated, broadly speaking, by the same judges, and in the same manner, as are common law rights and defenses.

The cases under equity jurisdiction at the present time may for convenience be grouped under three heads:

1. Where the status or situation of the parties is such that the remedy at law is not available or appropriate (as in the case of husband and wife, or of partners prior to dissolution);

2. Where there is not a plain, adequate, and complete remedy at law (as where the remedy of damages is inadequate to do complete justice);

3. Where the subject matter of the action is particularly one of equity jurisdiction as a matter of history (as in the case of mortgages and trusts).

Two important remedies (now available only in equity, though very closely analogous to remedies formerly given by common law courts) should be noted.

The ordinary common law remedy is money damages; it rarely compels a person to perform literally and exactly what he has agreed, or is under other duty to do. He may refrain from doing it, and a court of common law can, and will, merely give judgment that he pay to the other party the estimated money equivalent of the loss sustained by the latter. In some cases a court of equity says this "money equivalent" is no equivalent; that "in equity and good conscience" one who is under a duty to do a thing should do that thing and not merely pay damages for not doing it; and a decree may be entered to the effect that he shall do that thing. A decree for specific performance of a contract is proper (notwithstanding the possibility of relief by restitution, replevin, or mandamus) as against one who has committed or threatened a breach of contract if the legal remedy of money damages would not be adequate, as in the case of a contract for the transfer of an interest in land. In considering the adequacy of the legal remedy of money damages regard should be had to the degree of difficulty in evaluating accurately the subject matter, the effect of breach and the harm to the complainant, sentimental and aesthetic values which cannot be estimated in money, the difficulty or impossibility of obtaining performance by money damages, the collectibility of money damages, and the liklihood that multiple litigation will be necessary to collect compensation. Specific performance is discretionary and will not be decreed as to a promise to render personal service or supervision or where it would constitute a preference.[1]

Again, a court of law has no preventive jurisdiction; it can act only after a legal injury has been sustained. If the wrongdoer has no property out of which he may be compelled to pay damages, a common law judgment against him is an empty form. In some cases, however, a court

1 Compare generally the *Restatement of Contracts*, §358-§380.

of equity may intervene before the wrong has been done and, on the ground that it is against "equity and good conscience" to inflict irreparable injury, may enjoin (forbid) the doing of the wrong. The common law can give a remedy only after the harm is done (and then only a judgment for money damages against individuals who may be execution-proof). A court of equity may forbid the respondent to do the illegal act from which the complainant justifiably anticipates harm.

(c) *Statutes.* Whether legislation was a Roman idea brought to England by missionaries or is to be held ancillary to the judicial power in political history, it came to be taken for granted as a governmental function only with Parliamentary supremacy in the seventeenth century, with the conviction that changes of custom could no longer keep pace with social changes. Hitherto law in England had meant primarily custom; and interference with custom was proper only as to details and during an emergency, after consultation with the magnates. In this orthodox view it is something exceptional, with no necessary or systematic relation to the general body of the common law, introduced not as an expression of principles but to meet a special situation and that only. The scope of legislation today is restricted only by constitutional limitations (of state and federal constitutions). A few Western states have adopted the so-called Field Code, and Georgia has a complete civil code. An important field of legislation is that represented by the Uniform State Laws, proposed by the Commission on Uniform Laws, of which one (the Negotiable Instruments Law) has been adopted in every state in the Union, and another (the Sales Act) has been adopted by more than thirty states.

(d) *Law Merchant.* The history of the law merchant in the local courts, and later in the royal courts, has been briefly set out. It consisted of usages of trade in different departments of commerce proved in court and ratified by legal decisions, upon the assumption that persons entering upon transactions in different departments of trade dealt

with each other on the footing of any custom or usage generally prevailing in those departments, so that the usage is "engrafted upon or incorporated with" the law and accordingly binding on the courts.

Remittances in the international exchange by nonnegotiable bills of exchange, writings obligatory payable to bearer (known among merchants as early as the thirteenth century), order bills of exchange permitting one negotiation, the use of domestic bills of exchange between traders (and later by and between persons not traders) enforceable in the Court of the Lord High Admiral in the sixteenth century, the recognition of successive negotiations (though for a time held to constitute the indorsee merely the agent of the payee), and numerous presumptions in aid of the holder, followed as the use of these extremely convenient contracts in the development of trade extended. The negotiability of bills of exchange was apparently completely recognized "at common law" by the beginning of the eighteenth century. Bearer promissory notes were familiar in the time of Edward IV (the fifteenth century) but as late as the eighteenth century they were held not technically transferable except to attorneys, and in 1704 Lord Holt declared that (unlike bills of exchange) they had no proper place in the common law. They were made negotiable. by the familiar Statute of Anne of 1705. The quality which merchants desired and found in negotiable instruments (bills of exchange and promissory notes), and which the common law never admitted, may be stated most simply in terms of the basic difference between common law *assignability* (transferability subject to all defenses) and mercantile *negotiability* (personal defenses available to prior parties *inter se* not being available as against a holder in due course). In the eighteenth century merchants were encouraged (if not compelled) to try their causes in the common law courts, and the development of the law merchant was thereafter in those courts. The law merchant in the United States followed closely that of England. With the tremendous extension of commerce and its instru-

mentalities during the last quarter of the nineteenth century the imperative need of uniformity in the law of negotiable instruments found expression in the Negotiable Instruments Law of 1897, which has been adopted by every state in the Union, the last being Georgia (1924).

JURISDICTION

Jurisdiction is the authority of a court to hear and determine a pending controversy. Criminal jurisdiction (that is to say, authority to pass upon breaches of the duty to conform to rules of conduct enacted by the state in order to advance its welfare as such) is purely *local.* A crime against the laws of New York is not punishable as such crime anywhere in the world except in New York. Though the (international) extradition or (interstate) rendition of the accused may be requested, he cannot be tried for the crime except in the proper court in New York. On the other hand, most civil actions are *transitory;* that is to say, an action for a breach by the defendant in Connecticut of a contract made in New Jersey, or an action to recover damages for a tort committed by the defendant in Vermont, may usually be maintained in a court of New York if that court can get civil jurisdiction over the controversy. Civil jurisdiction in an action at law may be *in personam* or *in rem.* Jurisdiction *in personam* means that the defendant was served by a proper officer with process (a copy of the writ and summons in a common law action of contract or tort) while he was within the geographical limits within which the court has power. Such service gives the court authority to proceed with a final judgment binding on the defendant (and enforceable as such in other courts) whether or not he actually appears and answers. Jurisdiction *in rem* means that the action is begun by a proper officer attaching property of the defendant situated within the geographical limits within which the court has power. Here, as before, the court may proceed to final judgment, but that judgment is conclusive only in that court and as to that property, and is open to collateral attack as to the merits of the controversy.

On or before the return day of the writ the plaintiff must file his declaration (stating the facts necessary to constitute his cause of action) together with the writ (with the officer's return thereon) and the proper court fee. The defendant has then a certain length of time in which either to answer or to demur, or both. The answer may either deny categorically the allegations of the writ and declaration or declare the defendant's ignorance thereof (leaving the plaintiff to prove them if material), and/or it may state the facts on which the defendant intends to rely in avoidance. A demurrer challenges the legal sufficiency of the allegations of fact in the writ and declaration, claiming that they do not, as a matter of law, set out a cause of action. If the demurrer is sustained, judgment is entered for the defendant unless leave is given to plead over. If it is overruled, the case goes to trial on the writ, declaration, and answer. In equity the complainant's bill states the material facts relied on and the respondent's answer must specifically admit, deny, or explain each such material allegation or declare the respondent's ignorance thereof. (The respondent in equity may demur as may the defendant at law).

The purpose of the pleadings is to raise issues of fact. These facts are then established by trial, before a jury or otherwise (there is no jury in equity). Unless intervening motions prevent it, the case goes to judgment accordingly, ordinarily at some fixed time such as the first Monday of each month or week. A dissatisfied party may have alleged errors of law (but not questions of fact) considered by an appellate court. The judgment of the state court of last resort is final as to matters of state law, except that the Supreme Court of the United States at Washington may review:

1. A judgment deciding that a treaty or statute of the United States is invalid;

2. A judgment that a state statute is valid, where such statute was attacked on the ground of its being repugnant to the Constitution, treaties, or laws of the United States;

3. A judgment in any case involving any title, right, privilege, or immunity specially set up or claimed by either party under the Federal Constitution, laws, or treaties. The power to review in this case may be exercised as well where the Federal claim is sustained as where it is denied (Judicial Code, section 344 a, b).

The state courts are ordinarily divided into three classes:

(a) *Inferior Courts* — police, districts, and municipal (magistrates sitting without a jury) — with limited civil and criminal jurisdiction over a small geographical unit such as a city or group of adjoining towns.

(b) *Superior Courts,* with unlimited civil and criminal jurisdiction over a county — jury and jury-waived sessions, equity sessions, probate or surrogate courts, and land courts (where there is a system of land registration).

(c) *Supreme Judicial Courts or Courts of Appeal,* where jurisdiction is over the whole state, and is almost entirely appellate, though some of them still have original jurisdiction in equity and over prerogative writs.

In New York original jurisdiction is in the Supreme Court (trial terms and special terms), the County Courts, the City Court of New York, the Municipal Court of the City of New York, Justices Courts, and Surrogates Courts. Appellate jurisdiction is in the Supreme Court (Appellate Division) and thence in specified cases to the Court of Appeals (the court of last resort).

The federal courts are organized with the lowest unit the District Court of the United States, with jurisdiction over all or part of a state. Thus the four Federal Courts for the District of Maine, the District of New Hampshire, the District of Massachusetts, and the District of Rhode Island make up the First Circuit (which also has jurisdiction over appeals from the District Court of Puerto Rico). A federal court has diverse jurisdiction including criminal jurisdiction over offenses against the United

States, and civil jurisdiction in admiralty[2] and maritime cases, copyright and patent cases, and bankruptcy proceedings. There is also an important group of cases which, though begun in the State Court, may be removed by the defendant to the corresponding Federal District Court—including cases (where the matter in controversy exceeds $3,000 exclusive of interest and costs) involving a federal question (arising under the Federal Constitution laws or treaties) or diversity of citizenship (where the defendant is sued outside the state of which he is a resident),[3] cases where a nonresident defendant cannot get a fair trial in the state court because of local prejudice or influence, and cases where a defendant is denied a right secured to him by legislation providing for equal rights of citizens of the United States.

An alleged error of law on the part of the District Court may be re-examined by the proper Court of Appeals (of which there are ten), and special cases may be taken thence to the Supreme Court of the United States at Washington either by *certiorari* (in matters of importance and at the discretion of the Supreme Court) or by appeal or writ of error as a matter of right. This court is thus the highest court of appeal in all questions of law for the federal courts, and on federal questions for the state courts of last resort. By a recent decision it was held that lower federal courts are to follow the applicable state law (statutes and decisions) as to state matters.

Similarly the Supreme Court has held that a state statute of limitations applies to a civil action for equitable relief brought in a federal district court which has jurisdiction solely because of diversity of citizenship (*Guaranty Trust Co.* v. *York,* 65 Sup. Ct. Rep. 1464 [1945]).

---

2 Admiralty jurisdiction includes maritime contracts (charter parties, contracts of affreightment, demurrage, carriage of goods, marine insurance, freight, wharfage, towage, supplies and repairs, masters' and seamen's wages), torts (taking effect on navigable waters and concerned with the equipment, operation, and discipline of the vessel) and matters connected with the registry of vessels.

3 Similarly a plaintiff suing outside his state may begin the case in the Federal Court.

Part II: Contracts

Chapter III

PRELIMINARY DEFINITIONS

DEFINITION OF A CONTRACT

A contract is an agreement enforceable through legal proceedings. The elements of such an agreement are:

1. Manifestation of mutual assent,
2. Compliance with evidentiary requirements,
3. Reality of consent,
4. Consideration,
5. Capacity of contracting parties,
6. Legality of means and object.

Each of these elements will be the subject of a separate chapter.

CLASSIFICATION OF CONTRACTS

Some classifications will be explained in later chapters. Those given below are introduced at this point merely to remove the mystery that surrounds an unfamiliar terminology.

Formal and Simple Contracts. A formal contract depends for its efficacy upon being expressed in a particular form (deeds under seal, recognizances [conditional judgments], checks, other bills of exchange, and promissory notes). A simple contract depends for its efficacy not on form, but on the fulfillment of the six requirements enumerated above. A simple contract may be oral or written.

Executed and Executory Contracts. An executed contract is one that has been performed by all parties. An executory contract is one which has not been performed. A contract may be partly executed and partly executory. (E.g., A contracts to sell and deliver goods to B for $500 to be paid

in thirty days. A delivers the goods. The contract is executed as to A, executory as to B, as B has not yet paid the agreed price.)

Express Contracts and Contracts Implied in Fact. An express contract is manifested by the words of the parties, whether oral or written, or partly oral and partly written. A contract implied in fact is inferred from circumstances. (A steps into a taxicab and gives the driver a certain address. Having been transported to that address, A is bound to pay the fare, although he has not in words promised to do so.)

Contract Implied in Law (Quasi Contract). This is a misnomer. It means simply that in certain specified situations where A has conferred a benefit upon B, B must pay A the reasonable value thereof if B's retention of the benefit would constitute unjust enrichment at A's expense. (A, a doctor, renders first aid to B while the latter is unconscious as the result of an accident. B must pay A the fair value of the services rendered.)

Meaning of P and D. Unless the context indicates a different meaning, P is used throughout the following chapters to denote the person bringing suit (the plaintiff) and D to denote the party against whom suit is brought (the defendant).

Chapter IV

MANIFESTATION OF MUTUAL ASSENT

AGREEMENT

Agreement means that the minds of the parties have met on the terms of their bargain. Since the law cannot look directly into the minds of the parties, agreement must be inferred from their words or acts or both. Agreement, therefore, may be defined as a manifestation of mutual assent. Accordingly, if D signs a written instrument, he is ordinarily bound by its terms. It is immaterial that D could not or did not read the instrument or that he misinterpreted its meaning. All that is necessary is that D knew he was contracting, and that he was not tricked into signing. By signing D manifested his assent to the terms of the instrument. Agreement in this sense is to be distinguished from:

1. *Uncompleted negotiations* where the parties have not arrived at the point of agreement; as when the parties agree upon the lease of a building which is to be altered in accordance with "plans to be mutually agreed on" (in the sense of agreeing now that they will in the future agree on such plans as they can then agree on).

2. *Vague understandings* not sufficiently definite to be enforceable; as when a wholesaler agrees with a jobber to sell to him on such terms that he can meet competition in his territory.

3. *Provisional understandings* not to be effective until embodied in a formal record which is intended to be the binding and exclusive expression of the agreement. In some cases, however, the formal record may be no more than a convenient memorial of a pre-existing contract intended by the parties to be their final agreement. The execution of a

standard form of contract may thus be merely the expression, in a more formal document, of a bargain already made.

OFFER

An offer is a promise to act or to refrain from acting on condition that the person to whom the offer is made (offeree) acts or refrains from acting or promises to act or refrain from acting in the manner specified in the offer. (D offers to deliver certain property to P on payment by P of $50.) In a *bilateral contract* mutual promises are exchanged and each party is both promisor and promisee. In a *unilateral contract* the offeree exchanges for the offeror's promise something other than a promise.

Preliminary Negotiations Not Constituting Offers. Many business communications invite offers (advertisements, price quotations, trade circulars, catalogues). These media ordinarily are not sufficiently definite as to quantities, terms, and prices to indicate an intention to make an offer. Similarly, advertisements calling for bids on construction work, public or private, are generally regarded as mere invitations to offers. The person submitting the bid is the offeror, and, although many states provide that a public works contract must be let to the lowest responsible bidder, yet it is generally held that all bids, being but offers, may be rejected. Similarly, at auction sales the bidder is regarded as making the offer, which is accepted at the fall of the auctioneer's hammer. Accordingly, unless the auction is announced to be without reserve, the seller may reject a bid and withdraw the property from sale.

An Offer Must Be Communicated to the Offeree. An offer is not effective until it has been communicated to the offeree by the offeror or by his duly authorized agent. (There are two distinct firms having the same name, one located in Seattle, Washington, the other in Jacksonville, Florida. D intends to make an offer to the Jacksonville concern, but the letter containing D's offer is erroneously sent to the Seattle firm. The Seattle firm, surmising that the offer was intended for the Jacksonville concern, forwards the

letter to it. D's offer has not been communicated to the offeree, because the Seattle concern was not D's agent and had no authority to transmit the letter.) An offer includes only those terms which an ordinarily prudent person would take cognizance of. On this principle, matter printed in small type in the margin of a letterhead or on the back of a baggage check, ticket, or receipt may be of no effect where no reference thereto is made in the body of the letter or on the face of the ticket or token. One cannot be surprised into a contract. On the other hand, the microscopic printed conditions on the back of a bill of lading are sufficiently communicated because the average shipper is aware of them (although he may neither read them nor comprehend their import).

Termination of Offer. An offer may come to an end by:

1. Revocation. The offeror has the power to withdraw his offer at any time before it has been accepted. This is true even though by its terms the offer was to remain open for a definite time. To be effective revocation of an offer must be communicated to the offeree. If the revocation is embodied in a letter, it is communicated when the letter is received at the place of business or residence of the offeree. An offer made by a public announcement in a newspaper may be withdrawn by giving the revocation the same publicity as was given the original offer.

2. Rejection. To be effective the rejection of an offer must be communicated to the offeror. Any attempt by the offeree to change the terms of the offer amounts to a rejection. Thus, if D offers to sell property to P for $1,000 and P replies: "I will give you $800," P's reply is a counter-offer and operates as a rejection of D's original offer. P might have kept the original offer alive by stating: "I have your offer under advisement; would you be interested in a price of $800?"

3. Operation of Law. An offer comes to an end if the law is changed so as to make the contract contemplated

by the offer illegal, or if the offeror dies or becomes insane, or if any person or thing essential for the performance of the proposed contract dies or is destroyed before the offer has been accepted. Where the offer specifies a time within which it may be accepted, it comes to an end at the expiration of the stipulated time. If no time has been specified in the offer, the offer comes to an end after the expiration of a reasonable time.

Option Contracts. Frequently D offers to sell P certain property on specified terms, and provides that P shall have the option of accepting the offer within a certain time. If P pays D for this privilege the offer cannot be revoked by D within the time specified. In this case, D's undertaking that P shall have a certain time within which to decide is binding on D because D has received from P a valuable consideration in exchange for D's promise to keep the offer open. Such irrevocable offer is called an option. In some states an option under seal is equally effective. (In New York a written offer is irrevocable [if it so states] within the time specified, or [if no time is specified] within a reasonable time.)

ACCEPTANCE

Acceptance is the manifestation by the offeree of his assent to the terms of the offer. Mathematically stated, offer + acceptance = contract. Where D makes an offer to P to guarantee A's account and P delivers goods to A, D's offer of guaranty has been accepted by P's act in delivering the goods. In some states, however, it is held that D would not be bound unless P notified him seasonably of the credit extended to A: otherwise D might not learn with reasonable promptitude that he had become liable under the guaranty.

Offer Contemplating Unilateral Contract. An offer to enter into a bilateral contract cannot be accepted by doing an act. An offer to enter into a unilateral contract cannot be accepted by making a promise. If D offers P $50 to paint D's house, the offer can be accepted only by the completion of the performance requested. Accordingly, if, after P has

finished nine-tenths of the work, D says to P: "Stop, I withdraw my offer," there is no contract, but P can recover from D the reasonable value of the services he has rendered. The basis of D's liability here is not contract, but quasi-contract, to prevent an unjust enrichment at the expense of P.

Mere Silence Is Not Acceptance. P writes to D, offering to sell an automobile for $500 and states: "Unless I hear from you to the contrary, I shall understand that you have accepted this offer." If D disregards the letter and does not reply, there is no contract. D is under no duty to speak. However, if D were in possession of P's automobile at the time the offer was made and continued thereafter to use the auto, D's silence, coupled with conduct consistent only with acceptance and properly referable only thereto, might properly be found to indicate an assent on D's part to the terms of P's offer.

When Acceptance of Offer to Bilateral Contract Takes Effect. An acceptance of an offer to a bilateral contract is effective when assent has been manifested by some overt act, unambiguously referable to the offer and of a character to become known to the offeror. (P submits a proposed written contract to D which P has already signed. D then signs the contract and delivers it to P. D's act in signing and delivering the contract constitutes an acceptance of P's offer.)

Acceptance by Mail or Telegram. If an offer is made by mail, it can (unless the offeror has manifested other intent) be accepted by mail. In that event, the letter of acceptance is effective and the contract comes into being at the moment the letter is dropped into a United States mail box, properly addressed and bearing sufficient postage. Similarly, if the offer authorized acceptance by telegraph, telegraphic acceptance is effective, and a contract is created at the moment that the offeree delivers the telegram to the telegraph company for transmission to the offeror. The letter of acceptance may go astray in the mails: the telegram may not be delivered; there is nevertheless a valid contract. How-

ever academic this may seem, it is important to grasp the fact that an acceptance is effective when it is placed *in the channel of communication* expressly or impliedly authorized by the offer. In this respect acceptance differs from revocation or rejection, neither of which is effective until communicated. (If revocation or rejection is embodied in a letter, the letter must be delivered at the place of business or residence of the addressee.) Of course, an offer may specify that acceptance is not to be effective until the letter or telegram of acceptance has been received by the offeror, in which event no contract comes into being until the acceptance has in fact been received by the offeror. Finally, if the offeree uses some channel of communication not sanctioned by the offer, there will nevertheless be a contract if the acceptance is received in the time that it would have been received had it been properly sent.

Chapter V

COMPLIANCE WITH EVIDENTIARY REQUIREMENTS

THE ENGLISH STATUTE OF FRAUDS

In 1677 Parliament enacted the Statute of Frauds to counter the evil practice of giving false testimony in actions founded on certain kinds of contracts. The Statute of Frauds attempted to deal with the prevalence of successful perjury by making specified types of contracts unenforceable unless evidenced in a prescribed manner—in general, by a written memorandum signed by the party against whom liability under the contract was sought to be enforced.

STATE STATUTES OF FRAUDS

The states have enacted statutes similar to the English Statute of Frauds, and have in many cases extended the kinds of contracts whose enforceability is made to depend upon their being evidenced by a signed writing. In some instances such legislation is designed not to strike at false testimony, but to dispense with the common law requirement of consideration. The net result, however, is substantially the same: viz, if suit is brought on a specified type of contract, the defendant may defeat the action by affirmatively pleading that the contract sued on does not meet the statutory requirements as to form. Note that the defense of the Statute of Frauds does not avail a defendant unless *affirmatively pleaded*. Those contracts required in the Statute of Frauds of a given state to be evidenced in a certain way in order to be enforceable are said to be "within the statute." If such a contract is so evidenced, the Statute of Frauds is said to be "satisfied."

A TYPICAL STATE STATUTE OF FRAUDS

The following contracts are within the Massachusetts Statute of Frauds, which is typical:

1. A collateral contract by an executor or administrator to pay *out of his own assets* what is primarily an obligation of the estate he is administering;

2. A collateral promise to answer for the debt, default, or misdoings of another person;

3. A contract made in consideration of marriage (a marriage settlement). Mutual promises to marry (engagements), however, are not within the statute;

4. A contract for the transfer, creation, extinguishment, or purchase of an interest in land;

5. A contract which cannot be fully performed in the manner contemplated by the parties within a year from the time the contract was made;

6. A new promise to pay a debt, action on which is then (or later becomes) barred by the Statute of Limitations;

7. A new promise to pay a debt, action on which is barred by a discharge in bankruptcy;

8. A contract to make a will or to give a legacy or devise;

9. A contract to sell or a sale of goods or choses in action of the value of $500 or more. (A chose in action is an intangible interest or claim other than an interest in land, whether or not evidenced by a writing or token; e.g., D owes P $100 on open account: P's claim against D is a chose in action.)

New York adds to the above:

10. A promise of a proprietor of a hotel, inn, or steamboat to be liable for more than $500 if property delivered to him for safekeeping is lost;

11. An agreement to arbitrate;

12. An agreement not to be performed within the lifetime of either of the contracting parties.

COLLATERAL PROMISE TO ANSWER FOR THE DEBT, DEFAULT, OR MISCARRIAGE OF ANOTHER

A collateral promise is one which is merely subsidiary, incidental, or auxiliary to another (the original or principal

promise). A guaranty is ordinarily a collateral promise, hence unenforceable unless in writing signed by the guarantor. Thus, if R, a retailer, seeks credit from P, a wholesale merchant, P may insist that R furnish the guaranty of some third person. Assume that D, R's friend, orally states to P that D will be responsible for R's open account purchases during the ensuing year up to $5,000 if P will extend credit to R. D's oral promise is collateral, hence unenforceable. Note, however, that if D had requested P to charge the goods to D, that is, if P had extended exclusive credit to D, the oral promise would be original, hence enforceable. Similarly D's oral promise would be enforceable if P had been requested to extend credit to R and D *jointly.*

The following have been held to be original promises and hence not within the statute:

1. *Promise to discharge promisee's obligation to a third person.* D promises P to pay a debt (or to lend P the money to pay a debt) which P owes A. D's promise is not a promise to "pay the debt of another" but a promise to P to pay P's own debt.

2. *Substitution of one debtor for another.* D promises P to pay P what A owes P in consideration of P's discharging the obligation of A. If A's obligation is discharged, there is no outstanding principal obligation to which D's promise is collateral.

3. *Promises of indemnity or reimbursement.* D orally promises P to indemnify P against loss or damage caused P by A, or to reimburse P for loss incurred in assisting A.

4. *Main purpose: direct pecuniary benefit to promisor.* The purpose of the new promisor is to secure from the creditor a direct pecuniary or business benefit for himself. (D [junior mortgagee] promised to pay a note received by P [senior mortgagee] pursuant to an oral agreement that if D would make the required payments, P would forbear to foreclose.)

CONTRACTS FOR THE SALE OF AN INTEREST IN LAND

Under this section of the Statute of Frauds the term "interest in land" includes not only the absolute ownership (fee simple) but life estates and leasehold interests as well, except oral leases for not more than one year, which, in most states, are valid. Although trees and fixtures permanently affixed to a building are a part of the realty (real property), yet oral contracts for their sale are not within the statute and therefore are enforceable provided that the buyer is to acquire title to such trees or fixtures upon their severance from the land or building. However, such oral contracts may be unenforceable under the provisions set forth in section 5 or 9 of the statute on page 28. D's oral promise to P to procure A to transfer an interest in land is within the statute, whereas D's oral promise to P to act as P's agent to seek to procure A to transfer an interest in land is not.

Part Performance. Where, under an oral contract to convey land, the vendee (P) has, with the assent of the vendor (D), gone into possession of the land, paid part of the purchase price, made substantial improvements, and paid taxes, a court of equity may give specific performance to either party, whether on the ground that D is estopped to assert the statute or that the statute is satisfied by part performance (although the latter expression is manifestly inaccurate). Even though the circumstances do not warrant a decree of specific performance, the vendee may, if the vendor refuses to perform, recover payments made by him in reliance on the contract. To permit the vendor to retain such payments and at the same time refuse to perform would be to sanction an unjust enrichment. For the same reason the vendee may recover the reasonable value of improvements made by him on the property in reliance upon the vendor's performing the oral agreement to convey title.

AGREEMENT NOT TO BE PERFORMED WITHIN A YEAR

This refers to a bilateral contract which cannot in any conceivable set of circumstances be completely performed within a year from the time of making (not from the time performance is to commence). Thus, D's oral agreement to work for P for three years at a salary of $5,000 a year is within the statute and unenforceable. If D dies within a year from the date on which the oral agreement was made, his death would excuse further performance, but D would not have rendered the complete performance bargained for.

The following contracts are not within the statute:

Lifetime Contracts. D orally promises P for a valuable consideration to support P so long as P lives. This contract is possible of complete performance whether P lives five days or five years. (However, in New York, lifetime contracts are unenforceable unless in writing.)

Performance within One Year Possible. D orally agrees to build a two-story garage for P on P's country estate, for which, on completion, D is to receive $800. The date of completion is not specified. After working on the structure for a year and a half D quits. P has a valid claim for damages against D against which the defense of the Statute of Frauds will not avail. Although the work went on for more than a year, D could have finished the job within one year had he so desired. Similarly if the time of performance is to become fixed upon the happening of some contingent event (death, arrival of a specified ship, granting of a license, sale of property) the oral contract is enforceable, provided the contingency may occur within one year from the time the contract was made.

THE WRITTEN MEMORANDUM REQUIRED BY THE STATUTE

The statute does not require the agreement to be embodied in a formal written instrument executed by each of the contracting parties. It requires merely that the agreement be

goods. Mere retention of the goods by the buyer, even for an unreasonable length of time does not necessarily imply "acceptance" as this term is used in the Statute of Frauds.

Special Order Contracts. In those states which have adopted the Uniform Sales Act the Statute of Frauds does not apply "if the goods are to be manufactured by the seller especially for the buyer and are not suitable for sale to others in the ordinary course of the seller's business" (Uniform Sales Act, Section 4 [2]).

Chapter VI

REALITY OF CONSENT

CONSENT MUST BE GENUINE

A person may assent to the terms of a contract because of mistake, misrepresentation, fraud, duress, or undue influence. In that event his assent is not genuine, and he may avoid the contract (except in certain cases involving unilateral mistake).

MISTAKE

Unilateral Mistake. Where D contracts with P, a mistake on the part of P alone affords no basis for relief unless P's mistake is brought about by D's fraud or misrepresentation. However, if P's mistake was a mere clerical error apparent to D, D cannot take advantage of it, and P can avoid the contract. (A contractor submits a bid on construction work. The bid is based on estimates involving an error in computation. If the error is obvious, and the offeree perceives it before acceptance, he will not be permitted to take advantage of the contractor's mistake.)

Bilateral Mistake. Where parties enter into a transaction under a mutual mistake as to the existence of a certain state of facts assumed by both of them as the basis on which they entered into the transaction, the contract is usually voidable by either party harmed by the mistake. (D sells Blackacre to P. Both D and P assume, and the contract recites, that Blackacre contains 1,000 acres. In fact, Blackacre contains only 500 acres. P can rescind the contract.) The weight of authority supports this principle not only where the mutual mistake relates to the existence or identity of the subject matter, but also where it relates to the nature of the transaction. P can avoid a contract with D where P was

mistaken as to D's identity if (1) D's identity was material, (2) the mistake was caused by fraud on D's part, and (3) innocent third persons will not be harmed by avoidance of the contract. Mistakes by both parties relative to different matters afford no ground for relief; rescission may, however, be granted where both parties make different mistakes relating to the same matter.

Reformation for Mistake. On clear evidence that a mistake was made in reducing to writing the agreement of the parties, a court of equity will reform the writing to conform to the mutual intention of the parties. (P contracts to sell Blackacre to D. In the deed the property described is Whiteacre. Equity will reform the deed unless D has already reconveyed Whiteacre to C, who purchased in good faith and for value and without knowledge of the error made by P in the original conveyance to D.) If a transaction is required to be evidenced by a writing under the Statute of Frauds, a mutual mistake in such writing precludes enforcement of the executory contract; by definition such writing must correspond with the agreement in fact made by the parties. However, if there has been part performance, or a conveyance which violates the identical intention of both parties, reformation may be had.

Mistake of Law. Mistake as to the general law (a mistake as to the legal consequences of an assumed state of facts), unaccompanied by any mistake of fact, has been broadly stated to afford no ground for relief (it is still generally held that money paid under a mistake of law is irrecoverable); but a mistake as to one's private antecedent rights, dependent upon the existence of particular facts and the legal interpretation thereof, is often treated (especially in equity) as a mistake of fact justifying rescission. Thus a mistake as to the title to property, or as to the existence of certain particular rights (though caused by an erroneous idea as to the legal effect of a deed, or as to duties and obligations created by an agreement), is treated as a mistake of fact. When D (ignorant or mistaken as to his individual rights) enters into a transaction (whose scope and operation

he understands correctly) for the purpose of affecting his assumed rights, equity will treat his mistake as analogous to a mistake of fact.

MISREPRESENTATION

A statement may be false and yet D (the person making it) may believe it to be true. Such statement is an innocent misrepresentation. On the other hand if D knows the statement to be false or makes it with a reckless disregard as to whether it be true or false, the misrepresentation may be fraud or deceit. A contract induced by D's material (though innocent) misrepresentation to P (made before the contract is entered into) is voidable at the instance of P. "Material," here, means likely to affect the conduct of a reasonable man with reference to a transaction (statement as to quality of goods offered for sale by D, or as to D's character or credit; or an innocently erroneous estimate furnished by D on the basis of which P agrees to do certain construction work for a specified sum).

While a contract induced by an innocent misrepresentation will not ordinarily give rise to an action at law for damages, the misrepresentation may be set up in defense to an attempt to enforce the agreement. If, however, the representation is incorporated as a substantive term of the contract, it may have the effect of a warranty or a condition, depending upon the intention of the parties. If the representation is a *warranty* and is not in accord with the facts, P may rescind or hold D liable in damages for breach of warranty; if the representation is a *condition* and not in accord with the facts, no contract comes into being.

FRAUD

Fraud involves the following elements:

1. A representation by D as to a material fact,

2. Which D knows to be false *or* which D makes as of his own knowledge but with complete and reckless disregard of its truth or falsity,

3. Intending P to act in reliance on it, and
4. Which is acted upon in proper reliance by P,
5. With consequent legal harm.

When Silence Is Deceitful. Mere silence is not a representation and therefore is not fraudulent. D is under no duty to inform P of facts known only to D although such facts materially affect the value of the subject matter of the bargain. However, a seller may be bound to inform a buyer as to a defect known to the seller and not apparent on an ordinary inspection (a latent defect). Furthermore, where D is under a fiduciary relation to P, D must make a full disclosure of any pertinent information which he may have.

Active Concealment. Conduct as well as words may be deceitful. D sells P a table. Before exhibiting the table to P, D has endeavored to conceal a crack in the surface by filling it and repolishing. If P buys the table, the defect being no longer apparent on inspection, D's conduct is just as fraudulent as though he had said to P: "This is a new table. There are no cracks in the surface."

Promissory Representation. Promissory representation is not a statement as to a fact and so is ordinarily not fraudulent. A person may, however misrepresent his state of mind. (P owns two adjoining lots, on one of which P's home is situated and the other of which is vacant. D buys the vacant lot, stating that he intends to construct a residence thereon. Instead, D immediately erects a gasoline filling station. P can rescind the conveyance. D misrepresented his intention. Present intention is as much a fact as any other fact.)

Statement of Opinion. Representation as to a fact must be distinguished from a statement of opinion. (*Fact:* D, negotiating with P for the sale of a stock of merchandise states to P that the stock cost $5,000. *Opinion:* D states to P that the stock has a value of $5,000.) Statements of opinion purporting to be statements as to value (e.g., sales talk, sellers' puffing) accordingly cannot form the basis of

actionable fraud. A statement by D that he is the owner of certain property is a statement of fact though ownership involves matters of law. D's statement imports both a conclusion of law (that he is the owner of the property in question) and the existence of facts sufficient to justify that conclusion. Ordinarily, however, statements as to what is the law in a given situation are regarded as opinion unless made by a lawyer or one who has or purports to have expert knowledge. An exception to this rule is to be noted with reference to a misrepresentation of law by a fiduciary (a trustee, a guardian). Such a misrepresentation is actionable, being treated as a misrepresentation of fact.

When Reliance Is Justified. The fact that D makes a misrepresentation as to a material fact does not necessarily give rise to a cause of action based on fraud. P cannot shut his eyes to the obvious; and if he fails to ascertain the truth of a matter which he could have easily ascertained by reasonable investigation or inspection, he has no case. It does not follow that P under all circumstances is required to ascertain at his peril the truth of statements made to him by D. (D submits to P a financial statement. P does not have to employ his own accountants to go over D's books to verify the statement. P may rely on the truth of the statement which D submitted.)

Who has the right to rely on the truth of a representation? If D falsely represents to X that D is solvent, X may state to P, "D told me that he is solvent." If, now, P extends credit to D on the strength of the statement made to X, P has no remedy in fraud. It is assumed in this illustration that D's statement to X was made with the intent and reasonable expectation that X (and X alone) would act upon it; in other words, D intended to deceive X, not P. If, however, D has issued a false financial statement to a bank or a commercial agency, intending and expecting that such statement would be communicated to and acted on by others, the situation is quite different. In that event, if P, on the basis of such false statement which has been communicated to him by the bank or mercantile agency, extends credit to

D, the false representations contained in the statement constitute fraud as to P.

Effect of Fraud. Where B has been damaged by A's fraud, B may have a choice of the following remedies:

1. B may set up A's fraud as a defense to an action for damages for breach of contract brought by A as against B.

2. B may elect to carry out the contract and sue A for damages sustained by reason of A's fraud.

3. B may offer to restore the consideration received by B under the contract and sue for the return of the consideration furnished by B to A (rescission). This remedy B must avail himself of with reasonable promptitude after B learns of the fraud practiced upon him. Otherwise B waives his right to rescind.

4. B may have an action against A (in tort) for conversion.

Remedy 2 is inconsistent with remedy 3, and once B has decided on a course of action, he is bound by his choice. (B is fraudulently induced to purchase stock. He continues to receive the dividends after he learns of the fraud and exercises voting rights incident to his stock ownership. B can sue A for damages, but he cannot rescind. His course of action manifested an intention to confirm the contract and he cannot now adopt an inconsistent position involved in the remedy of rescission, which has for its purpose the undoing of the contract and the restoration of the parties to their status before the contract was made.)

DURESS

Duress of the person (P) means that P's will has been overcome by the wrongful coercion of D, or of some other person. Such coercion may take the form of a compulsive act or of a threat engendering fear. Either the act or the threat brings about an involuntary manifestation by P of his assent to the transaction. The threat of personal violence or wrongful imprisonment (even on civil process) constitutes

duress, whether D threatens to inflict such violence or imprisonment on P or on someone closely related to P by blood or marriage. A threat by D to interfere with P's contract rights or to damage P's property, if it overcomes P's will and judgment, constitutes duress (duress of goods).

Effect of Duress. If P is compelled to manifest apparent assent to a transaction whose nature he neither knows nor has reason to know, or if he is a mere mechanical instrument without directing will, the transaction so apparently assented to by P is void. If he knows or has reason to know the nature of the transaction into which he is compelled to enter, it is voidable by him. (If D at the point of a gun takes P's hand and signs P's name to a contract, the contract is void. If D had not seized P's hand, but had merely coerced P into signing under threat of shooting, the contract would be voidable by P.)

UNDUE INFLUENCE

Assume that P is under the mental domination of D, or is justified because of the relation between them in believing that D will act for P's welfare. Undue influence means that D has abused his ascendance and obtained P's assent to a transaction upon which he was unfairly persuaded to enter. A transaction between fiduciary (trustee, guardian, executor, or administrator) and beneficiary is strictly scrutinized. The beneficiary can avoid such transaction unless it was fair and reasonable and was entered into by the beneficiary with full knowledge of his legal rights and of all relevant facts within the knowledge of the fiduciary, and was entered into without undue influence.

Chapter VII

CONSIDERATION

A promise not supported by consideration is, in general, unenforceable.

DEFINITION OF CONSIDERATION

Consideration is:

1. *An act* which one is not under a legal duty to perform (D promises P to guarantee payment if P sells a bill of goods to X: selling the goods to X is consideration for D's promise); or

2. *A forbearance* (D promises P $500 if P will refrain from negotiating for the purchase of certain property: P's forbearance to do that which he has a legal right to do is consideration for D's promise); or

3. *A return promise* (D promises to pay P $50 in exchange for X's promise to D to sell D a typewriter for that price: the promises are consideration for one another).

Note that although consideration must be bargained for as the agreed exchange for the promise, "it matters not from whom the consideration moves or to whom it goes." Nor is it necessary that the consideration be "adequate" or equal in value to the promised performance, though a marked disparity in value may, in combination with other circumstances, be evidence of fraud.

CONSIDERATION IN SETTLEMENTS

Liquidated Debt. A debt is said to be liquidated if the amount is not in dispute. If D owes P a matured liquidated debt of $1,000, a part payment by D is not considera-

tion for P's promise not to sue for the balance, since D in making the part payment is merely discharging in part his legal obligation to P and not incurring any detriment. If, however, D makes a part payment before the maturity of the indebtedness, or in addition to making the part payment gives P, at P's request, a book worth $1.50, P's promise not to sue for the balance of the indebtedness will then be enforceable as D has incurred detriment, i. e., by payment before maturity or by giving the book. He has done something that he is otherwise not required to do. Again, if the original indebtedness of $1,000 was on open account, and at the maturity thereof D gave P D's promissory note for $500 in full settlement, this mere change in the form of the obligation would be sufficient consideration to support P's promise not to sue for the balance.

Unliquidated Debt. Where the amount of indebtedness is in dispute, or at least not ascertainable by mere calculation, the debt is said to be unliquidated. P, a physician, sends his patient (D) a bill of $1,000 "for professional services rendered." D contends that he owes only $500. If P accepts $500 in full settlement, he is concluded thereby and cannot thereafter recover the balance which he claims to be due. This is true whether the debt was or was not due at the time of the settlement.

Composition Agreements. Frequently a businessman in financial difficulty makes a settlement with his creditors by which each creditor agrees to accept in full satisfaction of his claim a percentage of the amount due. Where such composition agreement is entered into by the debtor with two or more of his creditors, it is binding upon those creditors who assent thereto. The composition agreement referred to is to be carefully distinguished from composition agreements in bankruptcy, which, if confirmed by the court after approval by a majority (in number and amount of the creditors), are binding on all the creditors of the bankrupt, including those who have not assented to the terms of the proposal.

NO CONSIDERATION

Instances of promises unenforceable because of the absence of consideration are:

1. **Promise of Additional Compensation.** P agrees for $5,000 to construct for D a building, according to plans and specifications. When P has completed half the work he threatens to quit unless D agrees to pay him an additional $1,000. D so promises. P finishes the building. He cannot obtain judgment against D for more than $5,000. D's promise to pay an additional $1,000 was without consideration because P was then already under legal obligation to complete the building. Assume in the foregoing example that X, a prospective tenant, had a pecuniary interest in having the building completed within the time agreed and that X promised P the additional compensation of $1,000. X's promise would be no more enforceable than D's promise because in either event P was merely doing or promising to do that which he was already under legal obligation to do. Some courts, however, disregarding the logic of the situation hold that the promise of additional compensation, whether made by D or by X is enforceable.

2. **Illusory Consideration.** If D promises to sell and P to purchase all the glue that P may order from D during the ensuing year at a specified price, there may or may not be a binding contract, depending upon whether or not P has any actual requirements for the glue. If P is a bookbinder and uses glue, the contract will be enforceable notwithstanding the fact that it is indefinite as to amount. If, however, P is a wholesaler who has never carried or used glue and has no orders for glue on hand at the time the agreement is made, it will not be enforceable. In form this is a bilateral contract: a promise for a promise. In fact P is not obligated to buy a single pound. The agreement lacks mutuality of obligation and is therefore not a contract at all. (Note that the requirement of mutuality applies only to bilateral, not to unilateral, contracts.)

3. **Past Consideration.** If P has conferred a benefit

on D, *but not at D's request,* such executed performance on P's part will not support a subsequent promise by D to reimburse P for the benefit conferred. Past consideration is no consideration. (In New York a recent statute provides that a subsequent promise, supported by a past consideration, is enforceable if in writing and signed by the promisor.)

PROMISES ENFORCEABLE DESPITE ABSENCE OF CONSIDERATION

Some promises are enforceable although not supported by consideration. The courts do not always acknowledge this, but try to work out some technical consideration rather than admit an exception to the rule.

Charitable Subscriptions. A bare promise to contribute a sum of money to some charitable undertaking is not enforceable because of absence of consideration. If, however, the promisee on the strength of the promise makes commitments or enters upon the performance of the contemplated project (construction of a church, hospital, or community building) most courts enforce the subscription. Some text writers justify this result on the broad principle that where D promises to confer a benefit on P for some specific purpose, and P, in justifiable reliance on such promise, detrimentally changes his position, D should be bound even though his promise was not supported by any consideration. This theory is known as Promissory Estoppel, but the courts for the most part have tended to restrict its application to the charitable subscription cases.

Promise to Pay Debt Barred by Statute of Limitations. Statutes of Limitations prescribe the time (after the right of action first accrued) within which certain actions must be started. A promise to pay a debt which has been "outlawed" (action on which is barred) by the Statute of Limitations requires no new consideration. The promise may be expressed in words or it may be implied from an act such as part payment on the debt. Many states, as we have seen, require the promise, if expressed in words, to be in writing (cf. Chapter V, Statute of Frauds).

Promise to Pay a Debt Discharged in Bankruptcy. A promise to pay a debt action on which is barred by a discharge in bankruptcy proceedings is enforceable without any new consideration. Some states, however, provide that such promise to be enforceable, must be in writing, signed by the debtor.

THIRD PARTY BENEFICIARY

Creditor Beneficiary. If D owes X $500 and X owes P $500, D may promise X to pay P $500 and thereby cancel both debts. P in this case is said to be a creditor beneficiary, inasmuch as X, the promisee, is legally obligated to P. The states are divided as to whether in this situation P can sue D and recover a judgment on the promise which D made to X. Some courts deny P's right to sue on the ground that there is no privity of contract between D and P, D's promise having been made to X and not to P.

Donee Beneficiary. If X insures his life in the D company naming as beneficiary P, to whom X is in no way obligated, X's intention is purely to benefit P. (P in this case is called a donee beneficiary.) Nevertheless P can recover in all states on the policy. If, however, the contract is not one of life insurance the states are again divided as to the right of the donee beneficiary to sue on the contract. Some states limit the right to cases where there is a family or marriage relationship between P (beneficiary) and X (promisee), or to actions on covenants which a municipality exacts for the benefit or protection of its inhabitants. (A city makes a contract with a water company whereby the water company agrees to furnish water at a certain rate to consumers: P, a resident of the city, can compel the company to furnish water at the contract rate.) Many courts allow the donee beneficiary to sue in all cases on the ground that if P is denied the right to sue, no one can sue on the contract and recover substantial damages because X was not to benefit by the performance and therefore cannot be said to have been damaged by breach of the contract.

Incidental Beneficiary. If the contract was not made expressly for the benefit of P, the fact that P may incidentally derive some benefit gives him no right to sue. (E.g., A contracts with D for the erection of a building which will enhance the value of P's adjoining property. P will not be permitted to sue D for breach of this contract.) (O is the owner of property and C is the general contractor. C gives O a contractor's surety bond [furnished by D] to protect O against liens for labor and materials furnished. O would not be personally liable for such claims; hence materialmen and laborers suing on the bond would not be in the position of creditor beneficiaries. Can P, a materialman, sue on the bond? Some few courts have held that the bond was obtained primarily for the owner's protection and that there was no intention to confer a benefit on subcontractors, materialmen, and laborers. In many states, however, such bond has been held to benefit them as well as the owner, and accordingly subcontractors, materialmen, and laborers have been permitted to sue D on the bond to enforce their claims.)

Promise Made Directly to Beneficiary. If D owes X $500 and X owes P $500, D, at X's request, may promise P (not X) to pay P $500. P is the promisee in this case, and most courts permit him to sue on the promise. The cases frequently treat this situation as though it involved the right of a third party to sue on a promise made for his benefit, but this is incorrect as the promise here runs directly to P and not to X for the benefit of P.

Rescission of Contract Made for Benefit of Third Person. Where D makes a contract with X for the express purpose of conferring a benefit on P, X and D cannot thereafter rescind the contract without P's consent, P having a vested interest therein. Thus, if P is named as irrevocable beneficiary in a life insurance policy, X cannot substitute another as beneficiary without P's consent. Of course, if the policy provides that X shall have the right to change the beneficiary without the latter's consent the situation is different. Under such circumstances P cannot be said to have a vested interest in the contract.

Chapter VIII

CAPACITY OF CONTRACTING PARTIES

UNENFORCEABLE, VOIDABLE, AND VOID CONTRACTS

Unenforceable Contract. An unenforceable contract is one which is not legally enforceable by direct proceedings. Thus, where P sues D on a five year oral contract of employment, if D pleads the Statute of Frauds, the contract is not enforceable. Nevertheless, there is a contract, for if D did not affirmatively plead the Statute of Frauds as a defense, P would recover for damages for breach of the oral agreement.

Voidable Contract. A voidable contract is one which P may avoid either because P was induced to enter into the contract by some element rendering his apparent assent unreal (fraud or misrepresentation), or because P lacked contractual capacity at the time he made the contract, or because D committed some material breach of the contract which would justify rescission (avoidance) by P. However, until P effectively manifests his election to avoid the contract, it is treated as valid. The term "voidable" is often loosely and inaccurately used to refer to contracts which are unenforceable because they do not comply with the requirements of the Statute of Frauds.

Void Contract. A void contract is no contract. Therefore, the expression "void contract" is a contradiction in terms. However, the expression is often loosely used to refer to an agreement tainted with illegality. Such an agreement is ordinarily void as to all parties.

CONTRACTUAL DISABILITY

Legal persons are presumed to have contractual capacity, except infants, insane persons, married women (at common

law), intoxicated persons, and corporations. The disabilities of married women have been generally removed by statute, and in most states today a married woman has full capacity to contract. The contractual power of corporations will be considered in a later chapter in connection with corporations.

INFANTS' CONTRACTS

An infant is one who has not lived until midnight of the day before he is twenty-one years old. (P, born September 8, 1922, would become of the full age of twenty-one years if he should live to September 7, 1943, attaining his majority at the earliest minute on that day.)

Infants' Contracts Are Voidable. An infant may, with a few exceptions to be hereafter noted, avoid liability on any contract executed or executory, and regain whatever he has parted with. In most states it is a condition precedent to the exercise of this right of disaffirmance that the infant return to the other party the consideration he received, if he still has possession or control of it in its original or in a changed form; but if the original consideration consisted of money which the infant squandered or dissipated or other property which the infant no longer has in his possession, he may, nevertheless, rescind the contract and recover what he has parted with. Where he seeks to recover the price paid for tangible property (a bicycle or an automobile) he may do so, but a deduction will be made for depreciation or the value of the use of such property. The right of avoidance rests only with the infant and cannot be exercised by the other party to the contract. Although an infant can act as agent, his appointment of an agent should, like his other contracts, be voidable. However, many courts have held that the contract by which an infant appoints an agent is not merely voidable but void. Where D, an infant, misrepresents his age and thereby induces P to contract with him, P cannot hold D either in contract or in tort. To permit P to recover damages based on D's fraud would be indirectly to enforce the contract.

Limitations on Infants' Right of Avoidance. There

are three exceptions to the rule that an infant may disaffirm all contracts made by him whether executory or executed, viz:

1. CONTRACTS FOR NECESSARIES. An infant is liable for the fair value of necessaries actually received by him which he has no way of obtaining except by his own contract. His liability is to pay the reasonable value. This may be less than the contract price but in no event will the infant be liable to pay more than the contract price.

2. CONTRACTS VALIDATED BY STATUTE OR BECAUSE OF PUBLIC POLICY. Certain contracts of infants are validated because of public policy or by statute. In some states contracts made by an infant who is engaged in business are held to be binding. Statutes may impose upon the plaintiff the burden of establishing that the contract was provident from the standpoint of the infant. Similarly, statutes may validate the marriage of infants and provide that married infants have full contractual capacity (Iowa), or provide that infants over fifteen years of age may make a valid contract for life insurance (New York). Enlistment in the armed forces of the United States provides another example of an agreement binding upon infants.

3. CONVEYANCE OF LAND. In general an infant may disaffirm a contract before he is twenty-one or within a reasonable time after arriving at the age of twenty-one. Where an infant has conveyed land a different rule obtains in many states which hold that the infant cannot rescind the conveyance and revest the title in himself until he attains his majority.

Emancipation. Emancipation means that a parent surrenders his common law right to the child's services and therefore to his earnings. Emancipation may be expressed or implied from circumstances such as marriage, wrongful refusal of support by the parent, or the parent's consent to a minor's contract for services for his own benefit. Emancipation, however, does not enlarge the infant's capacity to contract.

Ratification. After reaching the age of twenty-one a

person can, of course, ratify a contract which he made during minority; he cannot ratify before he attains his majority because ratification involves that very contractual power which he lacks. Ratification may be implied by any conduct inconsistent with disaffirmance. (D buys a chattel — not a necessary — when he is nineteen and sells it to X after he is twenty-one.) The mere failure to disaffirm an executed transaction within a reasonable time after the infant attains his majority may of itself constitute notification. The infant may, of course, ratify his contract by an express promise which in some states is within the Statute of Frauds.

INSANITY AND INTOXICATION

Where D contracts while intoxicated or when under an insane delusion, he may have a power of avoidance similar to that of an infant. If, however, D has been declared insane by court decree, any contract entered into by him is not merely voidable but void.

INFANT'S RIGHT TO RESCIND AS AGAINST BONA FIDE PURCHASER

A bona fide purchaser is one who in good faith and for actual value paid has acquired the legal title to real or personal property. Assume that P, an infant, sells and delivers to X a set of books. The contract of sale is voidable and X's title to the books is likewise voidable. Assume further that X sells and delivers the books to D, who pays value for such books and takes them in good faith and without notice of the fact that X acquired the books from an infant. Can P recover the books from D, the bona fide purchaser? The common law answered this question in the affirmative, but the common law rule has been changed as to transactions falling within the Uniform Sales Act, so that P (in states where that act is in force) could not reclaim the books from D. P's remedy is to sue X for the value of the books as of the date of the contract. But if an infant conveys real estate the common law rule still prevails. No matter how many intermediate transfers may be made to bona fide pur-

chasers for value, the infant may, on attaining his majority, rescind as against the last grantee and revest the title in himself.

Substantially the same rules have been applied where P seeks to disaffirm on the ground that he was insane rather than that he was an infant.

It is said that P may disaffirm as against a bona fide purchaser if P was wholly without intelligence because of intoxication, but some courts protect D on the ground that P's condition when he dealt with X was a temporary liability voluntarily caused by his own fault.

CHAPTER IX

LEGALITY OF MEANS AND OBJECT

DEFINITION OF ILLEGALITY

A bargain is illegal if its formation or performance is criminal, tortious, or otherwise opposed to public policy.[1] Examples of illegal agreements are the following:

Agreements Violating Prohibitory Statutes. The legislature may intend a statute to be *prohibitory.* Thus, where P, not having a license, acts as a real estate broker, the statute may provide not merely that P forfeits his right to a commission but that P's act constitutes a crime. On the other hand if the statute imposed a fine on P as the *sole* penalty for acting without a license, the statute would be *directory* rather than prohibitory, and P (though subject to a criminal penalty) could recover a judgment for his commission. It is often extremely hard to determine whether the legislature intended a statute to be prohibitory or to be directory.

Contracts Made or to Be Performed on Sunday. States vary with respect to the validity of contracts made or to be performed on Sunday, and in every case local statutory provisions must be consulted. If a Sunday bargain is illegal, it cannot be ratified, but it can be adopted by agreement on a secular day.

Agreements Violating Usury Statutes. An agreement to pay more than the legally permissible maximum rate of interest for a loan of money is usurious. So, too, is an agreement to extend a money debt in consideration of the debtor's agreeing to pay more than the maximum inter-

---

1 *Restatement of Contracts,* §512. Copyright, American Law Institute; all rights reserved.

est rate allowed by law. The states vary both as to maximum permissible rates and as to the consequences of usury. Most states penalize the lender by denying to him the right to collect any interest whatsoever on the loan. In some states the lender forfeits not only interest, but principal as well; in others, the lender can collect interest at the legal rate. By court decision or specific statutory sanction the following transactions have been held not to be usurious:

1. **Finance Charges.** The fact that identical goods are sold at one price for cash and at a higher price on credit does not constitute usury. The finance or carrying charges normally incident to instalment purchasing are thus permissible, unless the form of the transaction is a mere device to conceal usury.

2. **Discounting** (as where a bank discounts a six months' note in the face amount of $1,000, bearing interest from date at 6% per annum: the borrower receives $970, the bank deducting six months' interest in advance).

3. **Service Charges.** P (lender) may require D (borrower) to pay the expenses incurred by P in good faith in making the loan (legal fees, recording fees) or in obtaining security for the loan.

4. **Sale of Pecuniary Obligations.** Assume that A holds D's two months' promissory note, bearing interest from date, in the face amount of $1,000, the note having been delivered to A in payment of merchandise. The law regards this note as a chattel which A is free to sell at any price. Accordingly if A sells the note to P for $750 (i.e., at a discount of 25%) P can recover a judgment against D on the note for the face amount of $1,000 plus interest and costs. If, however, A had indorsed the note to P by a general indorsement, thereby personally guaranteeing D's obligation, some courts would hold the transaction usurious as it involves a contingent obligation on A's part to pay $1,000 plus interest for the $975 which he received.

5. **Commission on Loan.** If P lends A's money to D, P may charge D a commission in addition to the maximum permissible rate of interest, but P may not charge such commission where he lends his own money.

6. **Loans to Corporations.** A corporation cannot avail itself of the defense of usury. Accordingly, corporate bonds or other pecuniary obligations may provide for any rate of interest, the maximum rate being determined not by law but purely by considerations of expediency.

7. **Small Loan Companies.** Most states have placed in a special category pawnbrokers' loans and loans (usually not over $300) made by small loan companies, so-called "personal finance companies." Statutes permit interest to be charged on such loans at maximum rates which in many instances are as high as 3½% per month — 42% per year.

8. **Excessive Interest after Maturity.** An agreement by D at the time of making the loan to pay P excessive interest after the maturity of the loan may be legal if it is not a colorable device,

as where it is contemplated that the loan shall not be paid at maturity.

Wagering Agreements. Assume that P and D make an election bet. D's promise is to pay P $50 if R is elected. P's promise is to pay D $50 if R is defeated. Assume, further, that R is elected. Now if D pays $50 to P, D will receive from P no performance whatsoever in exchange. Note, also, that D's obligation to pay was conditional upon the happening of an event (the election of R) which may be characterized as a "chance event" in the sense that at the time the bet was made neither P nor D had sufficient information to be certain of the result. Every wagering contract involves these three elements:

1. D's performance depends on chance,
2. P furnishes no performance in exchange for D's performance,
3. D's performance did not indemnify P for any loss sustained by P.

Wagering contracts must be distinguished from:

1. **Dealing in "Futures."** D may sell "short" to P 100 shares of X stock, that is, contract to sell and deliver stock that he does not own. D makes such contract with P in the hope that the market price of the stock will decrease and that he will be able to make a "covering" purchase at less than the price at which he sold to P. Similarly, D may sell grain or rubber for future delivery. Speculative transactions of this nature, if consummated on a stock or commodity exchange, provide for delivery at *some* time, and are therefore not wagering contracts. Dealing in "futures" is legal even though P never actually takes delivery, but instead makes a cash settlement with D based upon the market price of the stock or grain at the time fixed for delivery. But if the contract discloses an intention that there be no actual delivery but merely a settlement on the basis of difference in market prices, it is an illegal wager.

2. **Indemnity and Insurance.** Contracts of indemnification, although performance is conditioned upon some casualty, differ from other wagering contracts in that P, or some designated beneficiary, is to be indemnified or exonerated for loss caused by the existence or happening of the condition. Insurance contracts, although in a sense wagers on life or property, are regarded as socially desirable devices for spreading certain risks, and are therefore legal. The applicant for insurance must, however, have an insurable interest in the life or property insured. If P takes out insurance on the life of X, a stranger, the contract is an illegal wager, but if X is P's debtor, the contract is legal—and

P can collect the face of the policy even though at the time of X's death his debt to P had been paid.

Agreements Tending to Obstruct Justice. Bargains tending to obstruct the administration of justice are illegal; the following are examples:

1. **Maintenance** (D offers to pay P $100 if P will sue X: D's motive is to annoy X).

2. **Champerty** (P agrees to pay the expenses if D sues X, and D agrees to give P one half of any proceeds received by D as a result of said suit).

3. **Bargain to Conceal or Compound a Crime.**

4. **Agreement to Pay Witness More than the Statutory Fee.** The prohibition does not apply to an expert, but the fee of an expert must not be contingent on the outcome of a case.

5. **Bargains Restricting the Tribunal.** A bargain which unreasonably limits the court to which a party may resort (as between Federal and State Courts) or the time of suit is illegal.

Agreements in Violation of Public or Fiduciary Duty. The following are examples:

1. Bargains to influence legislation by bribery (lobbying).

2. Bargains by a public official that he will make a certain appointment.

3. Bargains to induce granting of pardons.

4. A bargain with a public service corporation as to the location or maintenance of public facilities in a manner opposed to the public interest.

5. A bargain by a corporate officer or shareholder (for consideration enuring to him personally) to exercise his power in the management of the corporation in a particular way.

Agreements Tending to Defraud or Injure Third Persons. Examples are:

1. Exemption from liability for wilful breach of duty.

2. Exemption from liability for negligence. Where D is a person charged with a duty of public service (a common carrier, an innkeeper), he cannot exempt himself from liability for damages caused by his negligence, but D may properly agree upon a reasonable limitation of the damages recoverable for injury to property caused by D's non-wilful breach of duty. (The valuation placed on goods by the shipper ordinarily fixes the maximum amount recoverable in the event the goods are damaged or destroyed in transit.)

3. Induced breach of contract—a bargain between P and D requiring breach of D's contract with A.

Agreements in Restraint of Trade. (Discussed under "Government Regulation of Business.")

RELIEF IN EXCEPTIONAL CASES

In some cases refusal to grant relief might result in the indirect enforcement of the illegal contract or be against the public interest. Accordingly, the following exceptions have been established to the general rule that an illegal contract will be neither enforced nor rescinded at the instance of either party.

P Ignorant of Illegality. P may recover compensation for performance rendered while he was still justifiably ignorant of the facts. (D requests P, a truckman, to transport certain crates said by D to contain machinery, whereas in fact the crates contain rifles, the transportation of which is contrary to law.) P may also recover where he is ignorant of statutory or executive regulations of a minor character relating to a particular business, and where he is justified in assuming that D has special knowledge of the legal requirements.

Protection of Certain Class of Which P Is Member. Many contracts are declared illegal in order to protect a certain class of persons. If P belongs to this class, the court will permit him to enforce the illegal contract and grant damages or rescission whichever is appropriate. (Mrs. P paid $50 to D, a matrimonial agent, in consideration of D's promise to introduce her to a prospective husband. Mrs. P was dissatisfied with the result and sued D to recover the $50. A marriage brokerage contract is contrary to public policy and therefore illegal. Yet in this case the court will not leave the parties where it finds them, for to permit D to retain the $50 would be to deprive of protection those very persons whom the law intended to protect by interdicting such contracts. Accordingly, a judgment rescinding the contract will be rendered in favor of Mrs. P.)

Knowledge by P of D's Illegal Purpose. P may know that D intends to make improper use of what he obtains under the bargain, but if P does nothing to further such wrongful use he may recover damages for what D has obtained, unless D's intended purpose involves serious moral turpitude or unless a statute prohibits recovery.

Parties Not in Pari Delicto (Not Equally Culpable). Where P and D, though both culpable, are not *in pari delicto*, P (the more excusable) may repudiate the bargain and recover any performance rendered or its value, provided P is not guilty of any serious moral turpitude. (P, in New Jersey, sells stock to D, a banking corporation in New York, taking in payment notes which it was illegal for D to issue. P may recover judgment for value of the stock sold to D).

Locus Poenitentiae (Opportunity to Repent). P may recover money paid D (or goods delivered to D) so long as the bargain containing an illegal provision is unexecuted in its illegal part unless P's entering into the agreement involves serious moral turpitude. (P and D make a bet and deposit the stakes with C. D wins the bet. P notifies C not to pay D. C nevertheless does pay D. P may recover the amount of his deposit from either D or C.)

Contracts Illegal in Part. Assume that D makes two promises to P in consideration of two acts, promise number 1 being illegal and promise number 2 being legal. If the two acts are apportioned so that act 1 supports promise 1, and act 2 supports promise 2, then promise number 2 is enforceable notwithstanding the illegality of promise number 1, unless the whole transaction involves serious moral turpitude or is prohibited by statute. If the contract is bilateral and involves the exchange of, say, P's two promises for D's two promises and one of D's promises is illegal, the other (legal) promise made by D is enforceable provided a corresponding legal promise by P was apportioned as consideration for it. But no part of the bilateral contract will be enforced if the illegal portion of the bargain is an essential part of it.

Effect of Supervening Illegality. In case of illegality supervening through change of fact or law, D must make return to P for performance rendered by P (or for a breach occurring) while it was legal. Where, however, the bargain was illegal when formed, it is not validated by a change of fact, except where at the time the agreement was

made neither party knew nor had reason to know the facts making it illegal. Similarly, a change of law will not validate a bargain that was illegal at the time of its formation, unless the legislation so declares.

CHAPTER X

ASSIGNMENT

MEANING OF ASSIGNMENT

Certain kinds of contract rights can be transferred (assigned). Thus, if A owes B $500, B can effectively assign this claim to C over A's protest. (A is the obligor, B the assignor, and C the assignee.) No consideration is necessary to validate the assignment by B to C: it may be a gift. But B must be the actual or potential owner of the right in order for the assignment to be effective as an executed transaction. In the absence of statutory provision, the assignment need be in no particular form: it may be oral or written, although the advantage of a writing is obvious.

WHAT RIGHTS CAN BE ASSIGNED

Contract rights (including all claims for money) are in general freely transferable except in the following cases:

Assignment Involving Change in Duty of Obligor. If A agrees to work for B, B cannot assign to C his (B's) right to A's services. To recognize such assignment as effective would be to materially vary the duty of A notwithstanding the fact that A could still hold B for the compensation agreed upon. Similarly if A agrees to sell goods to B on thirty days' credit, B cannot assign his right to C: C's financial position may be much weaker than B's, and to compel A to extend credit to C instead of to B would be to increase the burden of risk imposed on A by the contract.

Some Rights Not Assignable. There are certain claims not legally assignable at common law (future salary of a public employee, a pension granted in consideration at least in part of continuing future services, future alimony,

damages for an injury the gist of which is to the person rather than to property). But A may assign to P A's claim against D (otherwise assignable) for land, goods, or other property interests or for (assignable) money damages, although the claim is being (or must be) litigated (and P is to enforce it at his own expense, paying a share of the proceeds — unless P gives no other substantial consideration).

Contract Prohibiting Assignment. Where a contract between A and B prohibits assignment by B of his rights, and B nevertheless attempts to assign to C, C acquires rights against B by virtue of the attempted assignment, and A can, if he so desires, discharge his contract obligation by rendering to C the performance which he was bound to render to B. But C in most states acquires, by the attempted assignment, no enforceable right against A.

Assignment of Future Wages by Person Unemployed. One can assign only credits (rights) of which he is, at the time of the assignment, actual or potential owner. Hence if B is unemployed, he cannot make an effective assignment of future wages. Such future wages constitute a mere expectancy. If, however, B is employed, he may make an effective assignment of future wages, subject to statutory limitations which have been enacted in various states for the protection of workers. Such statutes commonly limit assignments to one-fourth of future wages, provide that only one assignment shall be satisfied at a time, and are designed to curb the practice of including wage assignments in contracts of conditional sale (instalment purchases) in such manner that the wage earner signs the contract of sale without realizing that he is at the same time making an assignment of his future wages.

DELEGATION OF PERFORMANCE

If A (general contractor) agrees to construct a building for B, it is understood that A will let out different parts of the work to subcontractors (plumbing, electric wiring). Since the contract is not of such nature as to require personal performance by A, A can delegate the work to X, and

B has no right to interfere with X's performance. So long as X builds in accordance with the plans and specifications, A's duty is fulfilled. If A, in addition to delegating to X the task of performance, has also assigned to X the right to collect payment, X will of course be in a position to enforce B's contract obligations. It cannot be overstressed, however, that such delegation of performance and/or assignment of rights by A *does not relieve A of his contract obligations to B*. If the building is not completed in conformity with the contract A is liable to B in damages, and that liability is not in the least affected by the fact that A may have delegated performance and/or assigned rights to X. (In most jurisdictions X would also be liable to B in damages, at B's election, if X had expressly or by implication assumed A's contract obligations.)

Of course, if B consents to substitute X as obligor for A, then we have a new contract (novation) and thenceforth only X will be liable to B for failure to perform. In general, duties that are neither personal nor confidential in their nature may be delegated, unless such delegation is forbidden by the contract or by statute or common law policy.

EFFECT OF ASSIGNMENT

Where B assigns to C a right against A, and C sues A, A may interpose against C the same defenses that he might have asserted against B, if those defenses are based on facts existing at the time of the assignment or on facts arising thereafter but before A knew of the assignment. (A bought goods from B at price of $500. The goods were defective and A promptly offered to return them. B refused to take the goods back and assigned the account to C, who sues A for $500. A may set up as a defense against C the defective character of the goods.) Thus it is said that the assignee stands in the shoes of the assignor.

EFFECT OF SUCCESSIVE ASSIGNMENTS

Where B makes two or more successive assignments (to C, D, E) of the same right against A, priority as between C, D, and E depends in most states on which of the as-

signees was the first to notify A of the assignment. Even in those states which give priority to C (the earliest assignee) irrespective of notice, A is protected if he has paid B or D without notice of the assignment to C. In such states, however, if A has paid D, C could recover from D.

ASSIGNOR'S WARRANTIES

Unless the facts show a different intention, B (assignor by assignment under seal or for value) impliedly warrants to C (assignee):

(a) That he will do nothing to defeat or to impair the value of the assignment;

(b) That the right as assigned actually exists, subject to no limitations or defenses except those then stated or apparent; and

(c) That any token, writing, or evidence of the right delivered to C as part of the transaction (or shown to him as part of the transaction, or shown to him as an inducement thereto) is genuine and what it purports to be.

He does not (by the mere fact of assignment) warrant that A (obligor) is solvent or will perform. A guaranty by B (assignor) that A will perform his duty is not within the Statute of Frauds, since his contract is entered into for a consideration wholly for his own (B's) benefit.

Chapter XI

INTERPRETATION OF CONTRACTS

DEFINITION OF INTEGRATION

Where the parties adopt a writing (or writings) as the final and complete expression of their agreement it is said to be integrated. An integration is the writing or writings so adopted.[1] An integration, then, consists of words and it is the function of interpretation to ascertain the meaning to be given to the words used by the contracting parties.

GENERAL STANDARD OF INTERPRETATION

Where there is an integration, the law attaches to words (or other manifestations of intent) the meaning which would be given to them by a reasonably intelligent person knowing all the circumstances surrounding the contract and all the business customs pertinent to the transaction. ("If . . . it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them he would still be held, unless there were some mutual mistake, or something else of the sort.") For example, a writing provided that the lessee should pay all taxes assessed against the lessor by reason of the lessor's ownership of the leased premises. *Held:* that these words did not include the lessor's income taxes based on his receipt of rental. If, however, the law gives to certain words an established meaning, such meaning is controlling (under Sec. 22 of the New York General Construction Law words of masculine gender include the feminine and neuter; similarly, many words and phrases used in deeds and contracts relating to real property have technical mean-

1 *Restatement of Contracts,* §228. Copyright, American Law Institute; all rights reserved.

ings). Where there is no integration, words or other manifestations of intent by A to B are given the meaning A should reasonably expect B to give them.

Primary Rules in Aid of Standards of Interpretation. A reasonably intelligent person would understand words in the ordinary meaning which they bear throughout the country. He would give to technical words their technical meaning. (An insurance policy limits the risk to "port risk in the port of New York." The technical meaning of these words can and should be established by expert testimony.) He would seek for the meaning of the agreement *as a whole* and would endeavor to clarify sentences or paragraphs of doubtful meaning in the light of the entire agreement. He would also examine the conduct and acts of the parties *after* the making of the contract for some indication of what they meant by the words used in their contract.

Secondary Rules in Aid of Standards of Interpretation. Our interpreter would, of course, prefer a reasonable to an unreasonable interpretation. (What is the meaning of "a royalty of 50 cents per 1,000 feet on all pipes for an output of 5,000,000 or less feet per year, and for all pipes of an output of over 5,000,000 feet per year at the rate of 30 cents per 1,000 feet"? Assume the output is 8,000,000 feet per year. Is the royalty $2,400 [8,000 × .30] or $3,400 [5,000 × .50 + 3,000 × .30]? Our interpreter would answer $3,400. To interpret the contract literally as calling for a rate of 30 cents per 1,000 feet on all when the output is more than 5,000,000 feet per year would lead to the absurd conclusion that the royalty on 8,000,000 feet is less than that on 5,000,000 feet.)

1. **Principal Apparent Purpose of the Parties.** A leased to B a roof for the purpose of erecting an advertising sign. The lease provided for termination by B if a "building" should be constructed on adjoining property of such height as to obscure the view of B's sign. There was erected on the roof of an adjoining building a sign which obstructed the view of B's sign. The court held that the obstructing sign was a "building" within the meaning of that term as used in the lease. Our interpreter, having in mind the principal apparent purpose of A and B as expressed in the lease, must have come to the same conclusion, notwithstanding the lexicographical difficulties in the way of such an interpretation.

2. **Specific Language Supersedes Generalities.** Our interpreter would assume that specific provisions, rather than general clauses, express the intention of the contracting parties.

3. **The Draftsman Not Entitled to the Benefit of the Doubt.** Where A drafts the contract and submits it to B, ambiguous language will be resolved in favor of B. A, more easily than B, could have prevented mistakes in meaning by careful choice of words.

4. **Writing Takes Precedence over Printing.** Where written provisions are inconsistent with printed provisions our interpreter will give effect to the former on the assumption that they express the true intent of the contracting parties.

THE PAROL EVIDENCE RULE

Under the parol evidence rule an integration cannot be varied or supplemented by prior agreements (oral or written) or by contemporaneous oral agreements. (A certificate of deposit does not specify that the money on deposit is to bear interest. An oral agreement for interest cannot be shown. It is reasonable to assume that the provision for interest would have been inserted in the certificate [the integration] if the parties had intended such provision to be a part of their agreement.)

Exceptions to the Parol Evidence Rule. Prior or Contemporaneous Agreements can supplement an integration in the following cases.

1. **Collateral Contract.** If the prior or contemporaneous supplemental agreement relates to the same subject matter as the integration, is consistent therewith, and is made for a separate consideration, or might naturally have been made as a separate agreement, it is not superseded by the integration. (D assigns mortgage to P, D guaranteeing payment of the mortgage; parol evidence is admissible to show that P, for a separate consideration, agreed to keep the premises insured for the protection of D.)

2. **No Consideration Stated in Integration.** Where no consideration is recited in an integration, extrinsic evidence to prove that there was in fact consideration is admissible. (A in writing promises to pay $500 to B: B orally promises in consideration therefor to paint A's portrait; parol evidence is admissible to prove B's oral promise with the result that both the written and the oral promises are operative.)

3. **Condition Precedent.** The existence of a contract may, without inconsistency, be made to depend on some contingency, and parol evidence of an oral agreement to that effect is admissible. (A delivers to B a written contract, saying: "This contract is not to go into effect until I obtain the loan of $5,000"; the making of the loan to A is a condition precedent to the existence of the contract. Parol evidence is admissible to prove the conditional delivery.)

When Parol Evidence Is Admissible. Agreements prior to or contemporaneous with an integration are admissible:

(a) *To establish the meaning of the integration* if it is ambiguous on its face or in the circumstances under which the parties contracted, but not to give it a meaning completely alien to anything its words can possibly express. (A written contract provides for the sale of goods shipped "Ex Peerless." There are two ships of that name. Parol evidence is admissible to show which of the two ships the parties referred to.)

(b) *To prove facts showing the agreement void or voidable* for illegality, fraud, duress, mistake, or insufficiency of consideration. (Where P sues D for rent due under a lease, D may prove by parol evidence that both parties contemplated a lease for an illegal purpose which P was to promote.)

(c) *To prove the falsity of recitals* of any fact in an integration. (P sues D on a promissory note made and delivered by D to P. The note bears on its face the statement that it was given "for value received." D may show that, in fact, no consideration was given for the note.)

USAGE

Usage is customary practice prevailing in a large or small district, among all or part of the people in such district or among those engaged in some particular trade. Usage cannot change a rule of law, but it does define the meaning of words used by the parties if:

(a) The parties manifest assent that it shall be operative; or

(b) Either party intends the effect of his words or other acts to be governed by the usage, and the other party knows or should know of such intent; or

(c) The usage exists in such transactions as each party knows or as is generally known by persons in such circumstances. (P sold D "current quality manila hemp" at a specified price. A clause of the contract provided for arbitra-

tion "in the usual manner." P may prove by parol evidence that a custom exists in the hemp trade to the effect that a price named in a contract represents merely a standard of value, and the actual price of the hemp is to be determined on the basis of its quality by an arbitration proceeding.)

Both Parties of Same Place or Occupation. If both parties are of the same place (and the agreement is to be performed there) the applicable usages of that place are operative, unless either party knows or should know that the other does not so intend. Similarly where both parties belong to the same group or occupation, group customs or trade usages are operative.

CONDITIONS

A promise is absolute if the duty of performance depends solely on the lapse of time. (D delivers to P D's six months' negotiable promissory note. The note evidences an absolute promise to pay at a definite time.) A promise is conditional if the duty of performance depends on the happening of some event other than the mere lapse of time. (A policy of marine insurance is issued on a vessel "lost or not lost." The vessel has already been lost at the time of issuance of the policy; i.e., the condition fixing the insurer's duty of performance has occurred.)

Condition Precedent. In the example last given the loss of the vessel was a condition precedent to the fixation of a duty of immediate performance on the part of the insurer. Note that the fact constituting the condition (loss of the vessel) occurred *before* the contract was formed. Usually the condition refers to some contingent *future* fact (insurance policy conditional on a specified kind of future loss). The condition may also be a present fact (sale of glass warranted to be shatterproof).

Architect's Certificate. Building contracts usually provide that the contractor, before becoming entitled to payments, shall furnish the certificate of a designated architect to the effect that the work conforms to the plans and specifications. Most courts treat the production of the certificate as a condition precedent, excused by the architect's death, insanity, or arbitrary caprice. Where, however, the architect acts unreasonably but honestly,

there is a conflict of authority as to the effect that should be given to his refusal to grant a certificate. Under such circumstances it would seem that production of the certificate should not be excused.

Condition Subsequent. A condition subsequent is a fact which will extinguish a duty to make compensation for a breach of contract after the breach has occurred. In practice, illustrations of such conditions in contracts are rare. Form is deceptive in this regard. Thus, a fire insurance policy provides that failure to notify the insurer within thirty days after the loss shall terminate the duty to pay. In form, failure to notify within thirty days is a condition subsequent, but in effect the giving of the prescribed notice is a condition precedent to the duty of immediate payment by the insurer. The same policy provides that suit must be started within sixty days after the rejection of a claim. Failure to sue within this time is a true condition subsequent since it extinguishes the insurer's duty of immediate performance which had previously arisen.

Concurrent Condition. Assume that P agrees to sell and deliver to D a typewriter for $35 in cash. Then P must either deliver or tender delivery before the duty of immediate payment arises in D. D, likewise, must either pay or tender payment before the duty to make immediate delivery arises in P. Thus, performance or tender of performance by each is a condition precedent. Such conditions precedent are called mutual and concurrent conditions. (A tender is an offer to perform if the other party simultaneously performs. The offer to perform must be coupled with "manifested present ability to make it good.")

Express Conditions. A condition is express because the agreement so provides. (A promises to pay B $500 for a certain automobile if it can develop a speed of 75 miles per hour.)

1. **Promise to Pay Money on Demand.** P lends D $500 which D agrees to repay "on demand." One would think that P could not successfully sue D for the debt without having made a preliminary demand for payment. But the law is not so. A promise to pay one's own money debt on demand is regarded as unconditional. However, P could not recover interest as damages unless he made a demand. In the case of bank deposits usage prescribes the necessity of a demand by the depositor as the condi-

tion of raising a duty of immediate payment by the bank, but in regard to individual money debts payable on demand, "on demand" is, to the extent indicated, a misleading expression. This peculiar rule is limited to promises to pay *money* debts on demand. If A promises to deliver to B on demand a certain type of cutting machine for which B has paid in advance, B has no right of action against A without first making a demand on A for delivery.

2. **Satisfaction of Promisor.** D's promise may be conditioned upon his being satisfied with P's performance. (D agrees to pay P $500 if P will paint D's portrait to D's satisfaction. P paints D's portrait and several artists testify to the excellence of P's work. D expresses dissatisfaction, which is genuine, but for which he can give no reason. D does not have to pay P.) But if the contract does not involve personal taste or preference, performance to D's satisfaction is interpreted to mean a performance that would satisfy a reasonable person. (P agrees to repair boilers to D's satisfaction. P can recover judgment on proof that the specified work was properly completed, notwithstanding D's expressed dissatisfaction, for "that which the law will say a contracting party ought in reason to be satisfied with, that the law will say he is satisfied with.")

Conditions Implied by Law (Constructive Conditions). A bilateral contract ordinarily involves an exchange of performances as well as an exchange of promises. Where goods are sold on credit, payment is not to be made at the same time as delivery, but payment is nevertheless regarded as the exchange performance for delivery of the goods. The parties may define the manner and extent to which their duties are dependent (express conditions). In the absence of such expressed intention, the law defines the relation between duties of performance (constructive conditions).

1. **Simultaneous Performances.** Unless a contrary intent is clearly manifested, mutual performances are concurrent conditions if the promises can be simultaneously performed. In a cash sale delivery and payment are concurrent conditions.

2. **Performances Not Simultaneous.** Where by the terms of the contract P's performance is due before D's, D's duty is constructively conditional on earlier performance being rendered by P. (P contracts to sell and deliver goods to D on sixty days' credit. Delivery of the goods by P is a condition precedent to D's duty to pay for them.)

Conditions Precedent Excused. Conditions precedent are excused (that is to say, D, promisor, becomes bound to perform without the existence or occurrence of the condition):

(a) *If D prevents or hinders the occurrence* of a condition or the performance of a return promise.

(b) *By a new contract* between the parties dispensing with the condition.

(c) *By waiver.* (A contract for the sale of goods specifies November 1 as the delivery date. The goods are not delivered on that day. On November 3 the buyer writes the seller that he will accept the goods if delivered by November 15. On November 6 the buyer writes the seller that he has changed his mind and does not want the goods. The buyer is duty bound to take the goods if delivery is tendered on or before November 15, provided the seller has materially changed his position after receiving the buyer's letter of November 3 and before receiving the buyer's letter of November 6. If the seller has not so changed his position, the buyer is not bound to take the goods, as a waiver can be withdrawn at any time before the other party has materially changed his position in reliance thereon.)

(d) *By voluntary receipt or retention of performance* known to be defective (though D may have had a right to recover damages therefor). (P agrees to complete a building for D by March 1. The building is not completed on that date and P continues the construction work with the co-operation or at least acquiescence of D. D has waived the condition: he elected to keep the contract alive and not treat the delay as a material breach. D must therefore perform his part of the contract, though he may have an action against P for damages caused by the delay in completion. The same principle applies where a buyer accepts goods after the agreed date for delivery.)

(e) *By some kinds of impossibility.* (P lends D $100. D pledges a ring as security and promises to repay the money on return of the ring. The ring is stolen through no fault of P. D must pay P $100.)

(f) *By D's repudiation or manifestation of inability.* (P agrees to sell and D to buy a famous painting for $5,000, payment and delivery to be made August 1, 1941. On May 10, 1941, D informs P that he will not take the painting. On June 1, 1941, P sells the painting to X for $4,000. P

sues D for $1,000 damages. In this action P need not show that he tendered delivery of the painting on August 1. Such tender was a constructive condition, but it is excused by D's repudiation. P need show merely that he would have made the tender on August 1 had it not been for D's repudiation.)

(g) *By tender of a check or currency.* If tender of a valid check or currency (not legal tender) in performance of an obligation to pay money is rejected without a statement that the medium of payment is the ground of objection, the tender is not open to subsequent objection on that ground if (upon such objection) legal tender could have been obtained and seasonably tendered.

Chapter XII

DISCHARGE OF CONTRACTS BY AGREEMENT OR BY PERFORMANCE

MEANING OF DISCHARGE

A contractual duty to render a specified performance may be discharged by agreement, by performance, by breach, by impossibility, or by operation of law. To say that a primary duty of performance has been discharged by D's breach means that a new duty has been substituted — D must make compensation in damages for his breach of contract. In general, the rules governing discharge of primary duties apply with equal force to the discharge of the remedial duty to make compensation in damages.

Discharge by Agreement Includes Discharge:

1. **By Nonoccurrence of Condition Precedent.** The nonoccurrence of a condition precedent within the prescribed time, where unexcused, discharges D's duty of performance. (P agrees to sell and deliver goods to D for cash. P's unexcused failure to deliver or tender delivery of the goods within the time specified discharges D's duty to pay for them. Similarly, D's unexcused failure to pay or tender payment excuses P's duty to deliver the goods. Note that P's failure to deliver excuses performance by D, but, of itself, it is insufficient to give D an action for damages: in order to have the right to bring such action D must tender performance.)

2. **By Occurrence of Condition Subsequent.** A duty of immediate performance may be terminated by a subsequent event. (P sells and delivers goods to D under a contract of sale or return, no term of credit being given. D returns the goods thereby discharging his duty to pay the price.)

3. **By Release or by Contract Not to Sue.** P lends D $500. P delivers to D a writing under seal (or for a sufficient consideration) stating that P releases D from the obligation to pay the debt. D's duty to pay is discharged whether the debt was due when the release was delivered or not. The same result could have been reached by a binding promise by P never to sue for the debt.

4. **By Agreement to Rescind.** The parties may agree to rescind their contract and if each party surrenders some rights the rescission is effectual. Just as consideration is necessary to validate the original agreement, consideration is necessary to validate

the agreement to rescind. In those states where a seal still retains its common law effect, a seal will take the place of consideration.

5. **By Accord and Satisfaction.** An accord is a valid contract between creditor and debtor for the settlement of the claim by some future performance other than that which is due under the existing contract. Satisfaction is performance of the accord, discharging the claim. As long as the accord is executory, the creditor has the power to repudiate it and insist on performance of the original duty. (P agreed to discharge a judgment against D, if D made payment up to a certain amount and then assigned to P a patent. D made payment as agreed, and then tendered to P an assignment of the patent which P refused to accept. P could enforce payment for the unpaid balance of the judgment. The result would have been different if P had agreed that the accord itself was to operate as an immediate satisfaction of the judgment.)

6. **By Account Stated.** Assume that there are cross accounts between P and D, and that an *accurate* computation shows that after subtracting P's debt to D, D still owes P $500. Assume, further, that P and D assent to the account as correct. Then, the matured debts have been discharged, and a new duty has arisen in D to pay P $500, the amount found to be due by the account stated. However, if unknown to P or D there was some error in the computation neither would be bound by his assent, unless the other had materially changed his position in justifiable reliance on the correctness of the account as stated. After the debt (even one unenforceable because of the Statute of Frauds or barred by the Statute of Limitations) has formed an item in an account stated, it must be taken that D has satisfied himself of its justice, and that it is a debt which forms good consideration for a new promise: P (the creditor) may reasonably be excused for not preserving the evidence necessary before D's admission.

7. **By Assignment.** An assignment to a third person may be effective, in which case the debtor's duty to the assignor is discharged; or it may be conditional, revocable, voidable, or unenforceable, in which case the discharge is subject to a corresponding infirmity.

8. **By Novation.** A novation is a contract operating as an immediate discharge of a previous duty, creating a new contractual duty and including as a party one who neither owed the previous duty nor was entitled to its performance. (A, a business man, sells his business to D. D agrees to assume A's liabilities. P, one of A's creditors, agrees to look to D for payment rather than to A. A's duty to P has been discharged: D has been substituted for A as debtor to P.)

9. **By Avoidance of Voidable Duties.** Thus, an infant can disaffirm his contract. Similarly, where P has been induced by fraud to contract with D, P can avoid the contract.

10. **By Cancellation or Surrender.** Where P (obligee) cancels or surrenders to D (obligor) a formal unilateral contract, P thereby manifests his intent to discharge D's duty.

DISCHARGE BY PERFORMANCE

Exact Performance. Discharge by performance should in strict logic be confined to exact performance, in the sense that a contractual duty is discharged by exact performance thereof. Less than exact performance by P, though creating a right in him, does not fully discharge him from his duty to D. It is, however, usual and convenient to state here the other degrees of performance and their legal results.

Substantial Performance. When P has unintentionally deviated from exact performance as to a matter of slight importance not going to the essence of the contract and readily compensable by damages, there is said to be substantial performance, and he may still recover on the basis of the contract price, leaving D to recover damages in a cross-action or by separate suit. (P contracts with D, a builder, for the erection of a building according to certain specifications. The specifications for plumbing work call for certain "standard pipe" of Reading manufacture. D erects the building, and unknown to D Cohoes pipe is used instead of Reading pipe. Cohoes pipe is the same in quality, appearance, and price as Reading pipe. The architect refuses to give P a certificate unless P does the work anew, which would involve the demolition at great expense of parts of the completed structure, the plumbing being encased in walls. P can recover a judgment against D for the contract price less an allowance for the difference, if any, in value between the two kinds of pipe. Usually, the allowance would be measured by the cost of replacement, but in this case the cost of replacement would be "grossly and unfairly out of proportion to the good to be attained.")

Value of Benefit. Where P has deviated (still unintentionally) as to a matter which does go to the essence of the contract, he may not recover on the basis of the contract at all. If the result of his work is of some benefit to the other party, he may recover the value of that benefit upon the theory of a contract implied in law (quasi-contract).

Application of Payments. Where D owes P a sum of money on an open account consisting of items each of which is past due, a partial payment by D is applied:

(a) *Where D directs certain application.* Application is made in accordance with D's instructions to which P assents by accepting the payment.

(b) *In absence of direction by D.* If D makes a partial payment but does not manifest his intention as to how it is to be applied, P may make any distribution he desires if he notifies D thereof within a reasonable time. P may even apply the payment to a debt which is unenforceable because of the Statute of Frauds or which is barred by the Statute of Limitations; but P may not apply the payment to a claim which is unmatured, disputed, or illegal.

(c) *Payment not applied by D or P.* If neither party seasonably exercises his power, the payment should be applied to the earliest matured debt to which P might have applied it.

Chapter XIII

DISCHARGE OF CONTRACTS BY BREACH

BREACH OF CONTRACT DEFINED

Breach of contract means the total or partial non-performance of any contractual duty of immediate performance by D, or the unjustified prevention or hindrance by D of performance by P, or the unjustified prevention by D of the happening of some condition essential to create a right in favor of P, or (except in a few states) anticipatory repudiation by D.

WHEN BREACH DISCHARGES DUTY TO PERFORM

A breach by one party to a bilateral contract, so material as to justify refusal to perform a contractual duty by the other party discharges that duty. Where the breach is total, remedial rights provided by law are substituted for all the existing contractual rights of the injured party, or can be so substituted by him. A partial breach gives rise to remedial rights which can be substituted by the injured party for only a part of his existing contractual rights.

MATERIAL BREACH: MUTUAL PROMISES DEPENDENT

Where mutual promises for an agreed exchange are dependent, a material failure of (or delay in) performance by one party to a bilateral contract (not justified by the conduct of the other) discharges the duty of the other to give the agreed exchange. Such failure of performance by P is called failure of consideration.

Materiality of P's Failure to Perform. No mathematical rule can be laid down by which one can determine when

P's failure to perform a promise discharges D's duty to perform the return promise. One can do no more than state the general considerations applicable to the problem, viz:

(a) The extent to which D will obtain the substantial benefit he anticipated;

(b) The extent to which D may be adequately compensated in damages;

(c) The extent to which P has partly performed or prepared to perform;

(d) The greater or less hardship on P in terminating the contract;

(e) Whether P's conduct was wilful, negligent, or innocent; and

(f) The greater or less uncertainty that P will perform the remainder of the contract.[1]

The doctrine of substantial performance (page 75) illustrates the application of these principles. To say that a contract has been substantially performed is but another way of saying that P's breach is not material. A further illustration is to be found in mercantile contracts providing for instalment delivery and payment. (P contracts to sell and D to buy two thousand tons of coal monthly, at a stated price payable monthly ten days after each instalment is delivered. P delivers one instalment, but makes defective delivery of the second. The Uniform Sales Act provides that it is a question of fact whether P's breach is so material as to justify D in refusing to go on with the contract. A similar question arises with regard to the buyer's delay in paying for one instalment.)

Materiality of P's Delay in Performance. In determining the materiality of P's delay in performance,

(a) P's failure to perform on the exact day agreed on does not discharge D unless the contract so provides or is such that performance on the exact day stated is of vital importance;

---

1 *Restatement of Contracts,* §275. Copyright American Law Institute; all rights reserved.

(b) In mercantile contracts, performance at the time agreed on is important; and D's duty is discharged if P's delay is considerable (P having in mind the nature of the transaction and the seriousness of the consequences) and if it is not justified by D's conduct;

(c) Less delay by P discharges D if P has not started to perform at all than if he has partly performed;

(d) P's delay must be greater in order to discharge D if it is a contract for the sale or purchase of land than if it is a mercantile contract.

Failure of Consideration as Condition Subsequent. Subsequent total failure of the consideration moving from P may, as a constructive condition subsequent, discharge an existing right of action for breach of contract by D. (P contracts to sell and D to buy a certain painting on July 1, 1941. D agrees to pay the price on June 15, 1941. D fails to pay as promised and P consequently acquires a right of action. Before July 1 the painting is destroyed by fire without fault on the part of P. P's right of action is discharged. Note that ownership of the painting was not to be transferred to D until July 1.)

Prospective Failure of Consideration (Breach by Anticipatory Repudiation). Anticipatory repudiation means that D (without justification and before breach)

(a) Positively stated to P (promisee, or other obligee under the contract) that he would not or could not substantially perform, or

(b) Transferred or agreed to transfer to A an interest in specific property essential for the substantial performance of his contractual duties to P, or

(c) By voluntary affirmative act made substantial performance of his contractual duties impossible or apparently impossible.

(D agrees to sell and P to buy goods at a stated price in the future. Before the time for performance arrives, the

price goes up and D informs P that he will not deliver the goods unless billed at the price in effect on the date of shipment. D has committed an anticipatory breach. P now contracts to buy similar goods from X at an advanced price, thereby changing his [P's] position. On the agreed delivery date D tenders to P the goods ordered at the price originally fixed by the contract. P is under no duty to accept the goods: the subsequent tender by D of correct performance is inoperative to prevent the occurrence of the breach at the time D's performance was due.)

AGREEMENT FOR LIQUIDATED DAMAGES

Contracts often contain provisions fixing the amount of damages in advance of any breach (a building contract may provide that the contractor is to pay $100 a day for each day's delay in completion). According to the Restatement such provision for "liquidated damages" is enforceable if the amount so fixed is a "reasonable forecast of just compensation for the harm caused by the breach and that harm is incapable (or very difficult) of accurate estimation." If, however, the amount fixed bears no relation to the actual damage and is so excessive as to constitute a fine or forfeiture, the provision (although designated in the contract as one for "liquidated damages") will not be enforced, and damages will be assessed in the usual way at the trial.

CHAPTER XIV

DISCHARGE OF CONTRACTS BY OBJECTIVE IMPOSSIBILITY AND BY OPERATION OF LAW

SUBJECTIVE AND OBJECTIVE IMPOSSIBILITY

If P and D contract, it may be impossible for D to perform, yet X or Y or Z might be able to render the performance called for by the contract. Here the impossibility is subjective — is due entirely to the inability of the individual promisor, and not to the nature of the thing to be done (objective impossibility). Subjective impossibility neither prevents the formation of a contract nor discharges a contractual duty. (D promises for a sufficient consideration to pay P $1,000 on July 1, 1931. D's only means of payment is a deposit in the X bank, and P knows this to be so. On June 15, 1931, the X bank fails, D receiving a final dividend of $200. D's duty to P is not discharged.) The discussion that follows relates to objective impossibility.

SUPERVENING IMPOSSIBILITY

Supervening impossibility, arising out of facts (occurring at or before the time when performance of a promise is due) which D (promisor) had no reason to anticipate and to whose occurrence he did not contribute, discharges D unless a contrary intent is shown. Thus D's duty to raise a crop on particular land will be discharged by a drought. It is not necessary that the impossibility be brought about by the elemental forces of nature (act of God, vis major): other causes will suffice. (D contracts to sell P a certain rare painting. Before ownership is transferred to P, X, a maniac, slashes and destroys the painting. X's act discharges D's duty.)

Where Promisor Assumes the Risk of Impossibility. D may make an absolute promise of a certain performance,

disregarding the possible happening of events that would make such performance impossible. D's promise is then interpreted as a promise to be answerable for proximate damage if performance becomes impossible. (D contracts to manufacture for P specified machinery. D's duty is not discharged by the fact that such manufacture would infringe existing patents.)

Death or Illness. The death of a particular person whose action is necessary for the promised performance discharges the duty to render that performance. Physical illness may have the same result. (D contracts to work as sales manager for P for five years. D dies or becomes permanently incapacitated at the end of the second year. D's death or illness discharges the duties of both parties.) (D is surety on a bail bond, binding him to produce X in court on a certain day. If on the day named X is so ill that an appearance in court would gravely endanger him, D's duty to produce X on that particular day is discharged.)

Nonexistence of Thing or State of Affairs Necessary for Performance. Assume that D contracts with P to sell him "half of the chromium contracted to be purchased by D from X" under a specified contract, and that X defaults and fails to make delivery to D. Then D's duty to P is discharged. Similarly, a contract to manufacture goods in a particular factory would be discharged if the factory were accidentally destroyed by fire, before the time necessary for manufacture had expired.

Supervening Illegality. A contractual duty is discharged where, subsequent to the making of the contract, performance is prevented or prohibited by law. Law in this context includes federal and state constitutions or statutes, valid municipal regulations, and judicial, executive, or administrative orders of federal and state judges and other public officers. Thus, where performance of a construction contract is stopped by order of the building commissioners, the contractor's duty is discharged and he is entitled to be paid pro rata for so much of the work as was completed

prior to the order. Similarly, D's duty to sell wool to P is discharged where government officers give D orders demanding that they be filled at once pursuant to the National Defense Act (passed during the First World War). Again, D's duty to carry P's goods is discharged where government officers commandeer D's vessels.

Unanticipated Difficulty Does Not Discharge Duty. The mere fact that performance of a promise is more difficult or expensive than the parties anticipated does not discharge the duty of performance. (Contractor's duty is not discharged where a partially constructed building burns before completion. D's duty to load a vessel is not discharged by the fact it cannot be done at the wharf as contemplated by the parties. D's contractual duty to lay gas mains is not discharged because the outbreak of war makes it difficult and expensive to procure the necessary materials.)

Partial Impossibility. Partial impossibility rarely discharges a promisor (D) beyond the extent of the impossibility (the remainder of the performance is seldom materially more disadvantageous to him, and if he can still perform the whole contract with only an unsubstantial variation he must do so); but it may justify refusal to perform by the promisee (P), which in turn may justify D's refusal to perform the possible part.

EFFECT OF D'S PROSPECTIVE INABILITY TO PERFORM

D may commit a breach by anticipatory repudiation. Such breach will discharge P's duty, but D will have to answer in damages to P. Again, D's duty may be discharged by objective impossibility (destruction of subject matter or means of performance, death or physical incapacity of D, supervening illegality). In this event, not only D's duty, but that of P as well, will be discharged.

Insolvency of D. Insolvency here means that D's liabilities exceed his assets or that D is unable to pay his debts as they mature. D's insolvency does not make it certain that his promise will not be performed. However, P should

not be required to perform after D has become insolvent unless D performs simultaneously or furnishes adequate security for performance. (P sells goods to D on terms of sixty days' credit. D becomes insolvent before P makes delivery. If D wants the goods he must either pay on delivery or furnish to P adequate security for payment.)

DISCHARGE BY OPERATION OF LAW

Discharge by Judgment. A contractual duty or a duty to make compensation may be discharged by the judgment of a court of competent jurisdiction in a proceeding between obligor and obligee. It is the policy of the law to prevent between the same parties more than one suit based on the same subject matter. Hence D may be under a duty to P, but if P sues D and judgment is rendered in D's favor because of P's failure to secure the necessary evidence, D's duty is nevertheless finally discharged by the judgment.

Discharge by Merger. Merger means that D's duty to P has been replaced by the same duty based on different operative facts, or that D's previously unliquidated duty to P has been liquidated. There may be a merger:

1. **By Judgment.** (D owes P $500 on D's promissory note payable on demand. P sues D on the note and obtains judgment for $500 plus interest and costs. The note is discharged by merger in the judgment.)

2. **By an Award Duly Made by Arbitrators** (except one merely fixing the amount of money owing under a pre-existing duty).

3. **By the Formation of a Sealed Contract** between the same parties for the same performance (except in those states where a seal no longer has its common law force, in which case the sealed contract has the effect of an informal writing).

4. **By an Informal Writing** between the same parties and for the same performance. The writing integrates (and so is the only source of determining) the agreement of the parties.

5. **By a Negotiable Instrument** delivered and accepted as full satisfaction.

Discharge by Material Alteration. Material alteration of a written contract, or of a memorandum within the Statute of Frauds, made with fraudulent intent by P (obligee) discharges the duty of D (obligor). Alteration by P is material as to D if it would (if authorized or assented to by D)

vary D's rights against or duties to P or injuriously affect his relations with third persons (such as changing the name of promisor or promisee, changing favorably or unfavorably the amount, time, or place of payment or interest rate, adding or deleting words of negotiability or a seal, changing the date if that changes the legal effect of the writing).

Filling in Blank Spaces. P's material fraudulent and unauthorized filling of blank spaces discharges D's duty under the writing but authority to fill in apparently appropriate words is implied unless circumstances show a contrary intent. (P lends D $1,000 and D gives P his promissory note payable in six months without interest. D signs the note and fills it in with the exception of the amount, which is left blank. P fills in an amount of $1,000. The note is a valid contract. If P had filled in an amount of $2,000, D would have been discharged.).

Part III: Sales

CHAPTER XV

ELEMENTS OF THE SALES CONTRACT

SALE AND CONTRACT TO SELL

A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price. A contract to sell goods implies transfer of ownership at some future time, whereas in a sale the transfer of title is for all practical purposes simultaneous with the agreement (purchase of a loaf of bread, a pack of cigarettes, a newspaper). The law of Sales has been codified by the Uniform Sales Act, which has been adopted by about two-thirds of the states. Except where otherwise stated, the present text adopts the rules set forth in the Uniform Sales Act. In some instances sections of the Act are embodied in the text verbatim.

Meaning of Goods. The subject matter of the contract may be "existing" or "future" goods. Existing goods are those owned or possessed by the seller; future goods are goods which the seller is to manufacture or acquire after the making of the contract to sell. "Goods" means tangible personal property, including emblements (the crops in the ground at the departure of a tenant whose estate has come to an end at a time he could not foresee — his right of emblements is his right to take these away), industrial growing crops, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale (trees, coal, mineral ores). "Goods" does not include choses in action (intangible property: debts, claims, book accounts) or negotiable instruments. Stock certificates, however, have been held to be "goods" within the meaning of the Sales Act.

POTENTIAL POSSESSION. Under the common law doctrine of potential possession, there can be a present sale of crops not yet grown or of the young of animals not yet born. The seller in such cases is conceived to have a potential interest (in the sense of a present interest in the property of which the thing sold is the product, growth, or increase). The Uniform Sales Act has abolished this doctrine, and provides that where the parties purport to effect a present sale of future goods, the agreement operates as a contract to sell the goods.

The Price. The *price* may be fixed by the contract, or may be left to be fixed in such manner as will be agreed, or it may be determined by the course of dealing between the parties. It may be made payable in any personal property (but not in real property); that is, sale includes barter or exchange of goods. Where there is a contract to sell or a sale of goods at a price or on terms to be fixed by a third person, the action of the third person is generally held to be final in the absence of fraud or such mistake as indicates bad faith or failure to exercise correct judgment; if (without fault of the seller or the buyer) he cannot or does not fix the price or terms, the contract or the sale is thereby avoided; but if the goods or any part thereof have been delivered to and appropriated by the buyer, the buyer must pay a reasonable price therefor. If such third person is prevented from fixing the price or terms by the fault of the seller or the buyer, the party not in fault may obtain redress. The agreement may be to pay a price fixed by reference to the market price as of a given date or to prices paid by other buyers in the neighborhood.

The price may be fixed in the alternative if the event upon which the amount was to depend so affected the value of the property as to justify the conclusion that the variation in price followed a real or supposed variation in actual value. Where the price is not determined in any of the foregoing ways, the buyer must pay a reasonable price. An agreement which omits any reference to price must be distinguished from an agreement which provides that the seller

and the buyer are thereafter to agree on the price. The latter is a mere agreement to agree. The buyer's promise is illusory, and the contract as such is not binding on either party; but if title has passed to the buyer (apparently the illusory nature of his promise does not prevent this passing when the parties so agree) and if he keeps the goods, he must pay a reasonable price therefore (to prevent unjust enrichment).

Statute of Frauds. Note that the Statute of Frauds (p. 33) applies not only to goods but to choses in action as well. It will be remembered that the statute may be satisfied by:

1. Acceptance and actual receipt of all or part of the goods; or

2. Earnest or part payment by the buyer; or

3. A written memorandum of the contract or sale signed by the defendant or his agent.

1. **Acceptance and Actual Receipt.** Acceptance and receipt may be either actual or constructive: actual, where the buyer manifests by words or conduct his assent to becoming owner of part of the specific goods and actually receives the same through change of possession; constructive, where such assent and receipt by the buyer may be inferred from his acts fairly indicating an assertion that he owns the goods. It is doubtful how far, if at all, mere words may accomplish acceptance and receipt. New York, for example, does not recognize the possibility of oral acceptance and receipt. In some states, if it clearly appears that the buyer accepted part of the goods not with intent to perform the whole contract and to assert his ownership thereunder, but with some other expressed intent, such acceptance is not sufficient to satisfy the Statute of Frauds.

2. **Earnest or Part Payment.** *Earnest* is some tangible thing given (with the object of binding the contract at the moment at which it is concluded) as a token of good faith and guaranty of performance. If the contract goes through, the earnest is returned or deducted from the price. If it goes off through the giver's fault, earnest is forfeited. Part payment means the executed and completed transfer of title to something of value by the buyer to the seller. Where the buyer gives a check and stops payment, the statute has not been satisfied unless it was agreed that the check was to constitute absolute payment rather than a means of payment. A mere oral agreement by the buyer to cancel an existing debt of the seller is not payment; but written acknowledgment of receipt takes the case out of the statute, as do account book entries or the surrender by the buyer of a note or other negotiable instrument evidencing his claim against the seller.

3. **The Memorandum.** The memorandum must state the substance of the transaction and contain:

(a) The names or identifying description of the parties, indicating which is the seller and which is buyer;

(b) A description of the subject matter sufficient to identify what is to be sold;

(c) In some states the memorandum must recite the consideration. It has been said that, on principle, executory performance which *will* become due from each party should be stated in the memorandum (as conditions qualifying the respective promises), whereas so much of the bargain as *has been fully executed* is no part of the "contract," "promise," or "agreement";

(d) A statement of other material terms of the sale or contract to sell.

SALE DISTINGUISHED FROM OTHER TRANSACTIONS

License. A license (whose fundamental meaning is "permission") is the grant (as by a patentee) of a privilege or authority to B (to do what B would not otherwise be justified in doing) by A (who possesses and retains a superior right or power).

Bailment. A bailment is a transaction contemplating no transfer of ownership, whereby A (bailor) transfers to B (bailee), or B rightfully retains, possession of personal property (usually for a special purpose, and to be returned upon the accomplishment thereof). Thus a pledge is a bailment of personal property as security for a debt, with an implied power of sale, after reasonable notice to redeem, if the debt is not paid at maturity. Likewise where A consigns goods to B for sale by B as A's agent, B receiving the money from the purchaser (C) under an agency or trust in A's favor, B is a bailee of the unsold goods. Even though B has the right to make himself a debtor to A (rather than a trustee for A) where he sells A's goods to another or to himself, B is nevertheless a bailee with respect to the unsold goods.

Conditional Sale. In a conditional sale the seller reserves the general title until some condition, usually the payment of the price, is satisfied; he agrees, however, to transfer the title when the condition is performed, and in the meantime the buyer has a right of possession so long as he is not in default.

Chattel Mortgage. In a chattel mortgage the owner of personal property (the mortgagor) makes a conditional transfer of the legal title thereto to another (the mortgagee) as security for the performance of some obligation by the mortgagor. In a chattel mortgage the transfer of the title is conditional (that is to say, as security, defeasible upon the condition subsequent of payment) whereas in a sale the transfer of title is absolute; the mortgagor has a right to regain the title, whereas the seller has not. A chattel mortgage is a transfer of title (but not merely or necessarily of possession) as security; a pledge is a transfer of possession (but not of title) as security. A bill of sale, absolute on its face, may be shown to have been mutually intended merely to stand as security for a debt, in which case it is treated for all purposes as a mortgage, the apparent seller being the mortgagor and the apparent buyer the mortgagee.

Contract for Services. When the predominant element in the transaction is service, and transfer of the title to personal property is merely incidental thereto, the transaction should not be held to be a sale of goods: accordingly (in a number of states) the innkeepers and restaurant keepers are regarded as making contracts of service rather than sales; the furnishing of food and the like is there held to be ancillary to the contract of service.

Contract for Work, Labor, or Materials. Under the Sales Act, the Statute of Frauds applies to a contract by S with B whereby S is to procure M to manufacture for S goods to be furnished by him to B, and also to a contract by S with B whereby S is to manufacture goods especially for B unless such goods are not suitable for sale to others in the ordinary course of S's business.

Sale in Bulk. Statutes generally provide that the sale in bulk of any part, or of the whole, of a stock of merchandise otherwise than in the ordinary course of trade, and in the regular and usual course of the seller's business, is fraudulent and void as against creditors of the seller unless certain formal steps are taken. These steps include the

making of an inventory of the goods to be sold and of a sworn list of all creditors of the seller (and the amount due each), and the giving of a notice of the proposed sale and of its terms to each of the creditors (personally or by registered mail) by the purchaser a certain time (usually five or ten days) before taking possession or making payment. Such statutes are usually held applicable to retailers (but not to wholesalers, manufacturers, or non-traders, or to firms organized to take over the seller's business). Whether the effect of failure to comply is to make the sale wholly void (without reference to actual fraud) or only prima facie fraudulent, depends on the particular statute — as does the right of a creditor against the proceeds of a resale of such goods or against the purchaser personally. Where the statute provides that noncompliance renders the sale void, and the goods are delivered to the buyer, it has been said that he holds them as trustee for creditors of the seller. If he indistinguishably mingles the seller's goods with his own, the seller's creditors can levy on all the merchandise thus wrongfully commingled. Under one type of Bulk Sales Act there is a requirement (of great practical importance to creditors) that the buyer withhold from the purchase price a sum sufficient to pay the seller's creditors.

CHAPTER XVI

WARRANTIES

EXPRESS WARRANTY

An action upon a warranty (originally an action of tort by one who had relied upon deceitful appearances or representations) may be maintained in tort without alleging either knowledge or negligence on the part of D. Any affirmation of fact or any promise by the seller relating to the goods is an express warranty if the natural tendency of such affirmation or promise is to induce the buyer to purchase the goods, and if he purchases the goods relying thereon. No affirmation of the value of the goods, nor any statement of the seller's opinion only, shall be construed as a warranty (Sales Act, Sec. 12). While there may be statements of fact as to the quality or cost of an article fairly importing actual consent to be bound for the truth of the representation (as that a jar of cold cream is "pure and healthful"), the law does not attach any liability to mere sales talk or to a seller's "puffing" or prophecy ("This suit will wear like iron" . . . . "This automobile is worth $500"). Furthermore, the buyer has no action for breach of warranty unless the statement made by the seller was, to some extent at least, an inducing cause of the purchase (one may purchase a car in reliance on its appearance and demonstrated condition and not on the erroneous statement as to its year and model). While it may be found as a fact that the parties did not intend a warranty to cover defects which the buyer must or should have observed upon inspection (or of which he knew otherwise), the seller may bind himself against even patent or obvious defects (manifest upon casual inspection) if the intent to do so is clearly evidenced; it cannot be ruled a defense (as a matter of

law) against an *express* warranty either that inspection (which the buyer failed to make) would have disclosed the defect or that the buyer relied on his own judgment as well as on the warranty (although there is no *implied* warranty as to defects which such examination should disclose). To constitute a warranty, it is not necessary that the word "warranty" or "warrant" should be used by the seller (a jury might properly infer that "23 barrels of blue vitriol" contained blue vitriol). Descriptive words ("one Queen Ann living room suite," "one fireproof safe," "5-ton used truck") may be used merely to identify the subject matter of the bargain, or may denote a type or kind. Whether descriptive adjectives are to be taken in a literal or primary sense depends on intention, which must be gleaned in accordance with the general canons for the interpretation of contracts. Under the Sales Act promissory statements ("This radio will get European stations" . . . . "This truck will do 12 miles on one gallon" of a specified kind of gas) may be warranties.

While it is not essential to a warranty that the statement be made by the seller at the time of sale, a statement subsequent to the bargain is not actionable if neither supported by consideration nor relied on by the buyer to his detriment. Where the property in the goods has not passed, the buyer may treat the fulfillment by the seller of his obligation to furnish goods as described and as warranted (expressly or by implication) in the contract to sell as a condition of his own obligation to perform his promise to accept and pay for the goods.

IMPLIED WARRANTY OF TITLE

There was originally no implied warranty of title although active concealment of the absence of title might be fraudulent. Then it was held that a bare assertion of title by one in possession was a warranty, and later the tendency was to hold the same as to one not in possession. It is said that the general rule that a sale is *per se* a representation of title is less than a century old. Under the Sales Act (unless a contrary intention appears) every seller of

goods warrants by implication of law that he has (or when title is to pass will have) a right to sell the goods, that they are not subject to any lien or other encumbrance not declared or known to the buyer, and that the buyer shall have and enjoy quiet possession of the goods as against any lawful claims existing at the time of the sale. (S sells to B a used automobile which was previously mortgaged to C, the mortgage having been duly recorded. B has no actual knowledge of the mortgage, and S does not inform B of its existence. S is liable to B for breach of the implied warranty against encumbrances. B's failure to search the record before purchasing is immaterial. C, of course, is protected by recording, but this in no way affects S's liability to B.) No warranty of title is implied in a sale by one not professing to be owner — e. g., in favor of a purchaser at a judicial sale. The sheriff sells "all the right, title, and interest" of the judgment debtor. Similarly, an auctioneer or mortgagee is not burdened with an implied warranty of title, or an implied warranty against liens or encumbrances. The risk of defective title here is on the purchaser, the circumstances surrounding such sales being sufficient to put him on notice as to interests of third persons in the goods.

IMPLIED WARRANTY OF FITNESS FOR PURPOSE

There is no implied warranty or condition as to the quality or fitness for any particular purpose of goods supplied under a contract to sell or a sale, except as follows: where (1) the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required, and (2) it appears that the buyer relies on the seller's skill or judgment. Then — whether he be the grower or manufacturer or not — there is an implied warranty that the goods shall be reasonably fit for such purpose. In the case of a contract to sell or a sale of a specified article under its patent or other trade name, there is no implied warranty as to its fitness for any particular purpose. If the buyer has examined the goods, there is no

implied warranty as regards defects which such examination ought to have revealed. Any words or conduct tending to show that the buyer was to take the goods "as is" will prevent a warranty being implied. If the seller is a dealer in food, and the buyer is buying for immediate consumption and relies on the seller's skill or judgment, there is an implied warranty that the article sold is fit for human consumption. Industrial purchasers usually furnish detailed specifications, an act which has been held to be inconsistent with the buyer's alleged reliance on the seller's judgment.

IMPLIED WARRANTY OF MERCHANTABILITY

There was originally no warranty of quality—*caveat emptor* applied except perhaps as to a dealer selling goods he knew to be unmerchantable. Under the Sales Act, where the goods are bought by description from a seller who deals in goods of that description (whether or not the grower or manufacturer) there is an implied warranty that they shall be of merchantable quality. The term "sale by description" should probably be confined to situations where the identification of the goods depends upon the description, as may be the case either in a contract to sell goods by describing them as of a certain kind, or in a present sale (as of all the goods of a certain kind—identified by the description—in a certain place). On the other hand, the purpose of the description may be to induce the purchase of goods otherwise identified rather than to fix the identity of the property sold.

Merchantability is not a warranty of quality in the sense of requiring a particular grade, but it does require identity between what is described in the contract of sale and what is tendered, in the sense that the latter is of such quality as to have some value. Judicial synonyms for "merchantable" include "salable," "standard," or "average quality" (of goods sold under a particular description). We have seen that where an article is sold under its patent or other trade name, there is no implied warranty as to its fitness for any particular purpose. Is there in such cases an implied warranty of merchantability (as there is in a sale of

definite goods precisely defined)? Authorities are divided on the question. With respect to food, however, courts have generally permitted a recovery against a dealer — even though the food was purchased under a trade name, and in sealed containers or wrappers — sometimes on the basis of an absolute warranty that the food was fit to eat, sometimes on an implied warranty of merchantability (which, in the case of food, is practically equivalent to the warranty of fitness for purpose).

IMPLIED WARRANTY OF CORRESPONDENCE

Where there is a contract to sell or a sale of goods by description, there is an implied warranty that the goods shall correspond with the description; and where the contract or sale is by sample as well as by description, it is not sufficient that the bulk of the goods correspond with the sample if it does not also correspond with the description.

In the case of a contract to sell or a sale by sample there is an implied warranty (a) that the bulk shall correspond with the sample in quality; (b) that the buyer shall have a reasonable opportunity to compare the bulk with the sample, except in C.O.D. sales where delivery is by carrier and no agreement has been made permitting the buyer to examine the goods before paying the price; and (if the seller is a dealer in goods of that kind) (c) that the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample. A sale by sample is one wherein the sample is itself a tacit assertion of the qualities of the bulk it represents, being shown as an inducement to the sale, connected with the contract by the circumstances attending the sale, and intended by the parties as the basis thereof — as distinguished from the mere exhibition of a sample. (A buyer received from the seller "small reference samples" about two inches square, woven to "show the pattern and the weave and the number of ticks and ends in the cloth." The use intended for these samples was simply to show the design and character of the cloth, the color and general

appearance.) Parol evidence that a sale upon written order was induced by the exhibition of samples has been held admissible.

WHO CAN SUE FOR BREACH OF WARRANTY

Since a warranty is to be construed as a contract of personal indemnity for damages suffered by the first buyer, the resale by A (the first buyer) to P of an article warranted by D to A is held generally (except where P sues as assignee of A) to give P no right of action for breach of the warranty (even though P assumes payment of the original price). There is some authority for permitting P to recover on the theory that the warranty follows the goods (on the analogy of a covenant running with the land).

TORT LIABILITY OF SELLER

In addition to the seller's contractual liability to the buyer for breach of express or implied warranty, the seller (D) supplying or manufacturing a chattel or selling a chattel manufactured by a third person, with knowledge that it is or is likely to be dangerous, may be liable in tort to P:

1. *For directly or indirectly supplying* the chattel to A when bodily harm is caused to P by its use (by A in the manner for which it was supplied), if D knows or should realize that it is (or is likely to be) dangerous for the use supplied, has no reason to believe that A will realize its dangerous condition, and fails to exercise reasonable care to give proper information.

2. *For negligently manufacturing* (or putting out as his own) a chattel known to be (or likely to be) dangerous for use, or which, unless made carefully or under a safe plan or design, D should recognize as involving an unreasonable risk of causing substantial bodily harm. (P was injured by the collapse of a defective wheel on an automobile purchased by him from a dealer. The automobile had been manufactured by D corporation, but the wheel had been sup-

plied by another manufacturer. *Held:* D was liable to P for negligence in failing to ascertain the defect in the wheel. D argued that its duty of vigilance was owed to the dealer, not to P. The court rejected this contention. Note that the manufacturer of the defective wheel was also liable to P in negligence.) Manufacturers have even been held liable in negligence for damage to property (as distinguished from injury to the person of P). P cannot ordinarily hold the manufacturer for breach of warranty (since P did not buy directly from D), but D may be liable to P on the theory of negligence.

3. *For deceit.* Here P has the burden of proving legal harm to himself as a proximate result of his justifiable reliance upon a representation by D (who knew or believed the matter to be otherwise or knew that he had neither confidence in, nor basis for, his representation) as to a material fact, opinion or law with intent to induce action or abstention by P in a business transaction, or from intentional and active concealment by D (thereby preventing P's acquisition of material information). The practical difficulties in the way of a recovery on this theory may be illustrated by a case where P was injured by a wire nail imbedded in a loaf of bread, on the wrapper of which was printed the statement: "This bread is 100% pure, made under the most modern, scientific process, has very special merit as a healthful and nutritious food." The court held that this statement merely negatived the use of unwholesome ingredients and was not a representation that there was no foreign substance in the bread. Hence, the printed statement on the wrapper was not proved false. Furthermore, even if the statement could be interpreted to assert absence of a foreign substance such as a nail, the plaintiff had failed to prove that D knew that there was a nail in the loaf purchased. Finally, inasmuch as P in requesting a loaf of bread, had not specified bread manufactured by D, there was no proof that he had relied on the statement in question.

4. *For negligence*: conduct falling below the standard

established by law for the protection of others against unreasonable risk of harm, being either *an act* involving what a reasonable man should realize is an unreasonable risk of causing an invasion of another's interest or *a failure to do an act* (necessary for the protection or assistance of another) which one is under a duty to do.

CHAPTER XVII

TRANSFER OF TITLE

IMPORTANCE OF FIXING TIME OF TRANSFER

Early English law (like Roman law) required delivery in order to effect change of title; but, before long, payment of the price was also held sufficient. The modern rule (disregarding form and seeking to effectuate manifested intent) is that title passes when the parties so intend, irrespective of delivery or payment. It may be important to fix the exact moment of time at which ownership or title (as distinguished from possession of the goods) passes to the buyer: [1]

1. If title has passed, a subpurchaser from the buyer may get absolute title. This is not so if title has not passed.

2. Where goods are lost or damaged in transit. The general rule is that risk follows the title, and hence it becomes necessary to determine who was the owner of the goods when loss or damage occurred.

3. Where the seller, still in possession of goods sold to the buyer, is petitioned into bankruptcy. Are the goods part of the bankrupt's estate, or must they be turned over to the buyer? The answer turns on whether or not title passed to the buyer before the petition in bankruptcy was filed. Similarly as to the right of creditors of seller or of buyer to make attachment.

4. Where the buyer wrongfully refuses to accept and pay for goods which conform in every respect to the con-

---

1 Although the importance of fixing the exact time at which title passes to the buyer is obvious, order forms and purchase contracts are generally silent on this point. A survey of order forms made at the Harvard Business School showed that "Order forms are weakest in specifying when title is to pass, and the Sales Act is at its worst in this respect so far as furnishing aid to the manufacturing purchaser is concerned."

tract. May the seller sue for the price (if title has passed, this is one of the three situations in which he may maintain such suit), or is he confined to an action for damages for breach of contract?

5. If title has passed, the seller loses his right to reclaim the goods upon repudiation by, or incapacity of, the buyer.

6. If title has passed, the buyer can maintain a proprietary action (conversion or replevin) for the goods.

INTENTION GOVERNS TRANSFER OF TITLE

It is fundamental that title passes when the parties intend that it shall pass. Intention is found in accordance with those general standards of interpretation which have already been considered. Regard must be had to the terms of the contract, the conduct of the parties, usages of trade, and the circumstances of the case. But what if (as is ordinarily the fact) there is no expressed intention, and none can be inferred from the terms of the contract, the conduct of the parties, usages of trade, and the circumstances of the case? Artificial presumptions must be resorted to. Rules for ascertaining intention have been formulated to meet different standardized situations, on the theory that such rules correspond to provisions which the parties would have inserted in the contract had they been aware of the necessity of fixing with exactitude the time at which title was to pass. Before considering these rules it is necessary to define the different kinds of goods which may be involved in a sale or contract to sell, viz:

1. *Ascertained goods* means goods that are identified and agreed upon as forming the subject matter of the bargain. Ascertained goods are *specific* if they belong to the seller and are identified and agreed upon *at the time* a contract to sell or a sale is made. If identification takes place afterward the goods are *specified* (or ascertained) but *not specific.* Existing goods (owned or possessed by the seller) may or may not be specific. Future goods (to be manufactured or acquired by the seller after the making of the contract to

sell) cannot be specific. (*Specific goods*: S sells B one used Mack truck, motor No. 66,714. S and B are on the truck when the bargain is made. The goods are existing, ascertained, and specific.)

2. *Unascertained goods.* The Act (while it does not directly define this term) uses it as the negative of specific goods — that is, goods which are not identified at the time a sale or contract to sell is made. Existing goods may or may not be unascertained. Future goods must be unascertained. (*Unascertained goods*: a retail grocer orders six dozen cans of X brand tomatoes from a wholesale concern. The wholesaler has the canned goods in stock, and accepts the order but does not immediately set aside six dozen. The goods are existing and unascertained. When six dozen cans have been set aside and earmarked for the retailer the goods have become ascertained or specified — not specific.)

ARTIFICIAL RULES FOR ASCERTAINING INTENTION (Sec. 19)

Specific Goods (Rules 1, 2, 5). Except in cash sales, title is presumed to pass when the contract is made, if the goods are identified and in the state contemplated by the bargain — that is, in a deliverable state, so that nothing but delivery of the goods and payment therefor remains (Rule 1). Even in cash sales the seller may waive the condition requiring payment of the price before title passes, as by voluntary and unrestricted transfer of possession for other than a temporary purpose, or by taking in payment a check that is later dishonored (some courts hold, however, that a worthless check given by the buyer is not payment, that no title passes to the fraudulent buyer, and that even an innocent purchaser from the buyer is not protected).

If the seller is bound to do something to the goods, for the purpose of putting them into a deliverable state, the property (title) does not pass until such thing is done (Rule 2). However, if the contract to sell requires the seller to deliver the goods to the buyer or at a particular place, or to pay the freight or cost of transportation to the buyer or to a particular place, the property does not pass until the

goods have been delivered to the buyer or have reached the place agreed upon (Rule 5). Presumably, where the contract is indivisible the title must pass to all the goods or none. Where weighing, measuring, or testing is necessary (not for the purpose of identifying the goods but solely for the purpose of fixing the price), some courts have held that title passes anterior to the performance of such acts (the weighing or measuring merely determines the price, but does not put the goods into a deliverable state).

Sale by Auction. In a sale by auction: Where goods are put up in lots, each lot is the subject of a separate contract of sale. Such sale is complete when the auctioneer announces its completion by the fall of the hammer, or in other customary manner. Until such announcement is made, any bidder may retract; and the auctioneer may withdraw the goods from sale unless the auction has been announced to be without reserve. A right to bid may be reserved expressly by or on behalf of the seller. If notice has not been given that such sale is subject to a right to bid on behalf of the seller, it shall be unlawful for the seller himself to bid or to employ or induce any person to bid on his behalf, or for the auctioneer to employ or induce any person to bid on behalf of the seller, or knowingly to take any bid from the seller or any person employed by him. Any sale contravening these rules may be treated as fraudulent by the buyer. In an auction sale title ordinarily passes when the hammer falls (even though the sale is "for cash") although if the sale is within the Statute of Frauds either party may effectively withdraw (or the owner revoke the auctioneer's authority) before the memorandum is signed. (If the seller temporarily retains goods struck down to the buyer under an arrangement with the buyer, and the goods are destroyed without fault of the seller, the loss falls upon the buyer, under the general rule that risk follows the title.) The auctioneer is personally liable unless his principal was disclosed. If the sale is announced to be without reserve, the auctioneer cannot withdraw the goods after the bidding has begun.

Unascertained Goods (Rules 4 and 5). If there is a contract to sell unascertained or future goods by description, and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in such goods thereupon passes to the buyer. Such assent may be expressed or implied, and may be given either before or after the appropriation is made. Such passage of title by mere appropriation is an extension of the theory of delivery formerly essential to the transfer of title. "Appropriation" means setting aside and earmarking the goods for the

buyer. Where the contract requires the seller to deliver the goods to a carrier, mere appropriation by setting the goods aside and packing them will be insufficient to pass the title. Title will not pass until the goods have been delivered to the carrier, since this is the "last act" which the contract requires the seller to perform with respect to the goods. When, in pursuance of a contract to sell, the seller delivers the goods to the buyer, or to a carrier or other bailee, whether named by the buyer or not, for the purpose of transmission to or holding for the buyer, he is presumed to have unconditionally appropriated the goods to the contract except:

1. Where the contract to sell requires the seller to deliver the goods to the buyer or at a particular place, or to pay the freight or cost of transportation to the buyer or to a particular place (Rule 5); or

2. Where the seller, by the terms of the contract or appropriation, reserves the right of possession or property in the goods until certain conditions have been fulfilled.

The presumption that delivery to a carrier is an unconditional appropriation effective to pass title to the buyer is applicable, although by the terms of the contract, the buyer is to pay the price before receiving delivery of the goods, and they are marked with the words "collect on delivery" or an equivalent.

The presumption of unconditional appropriation (and so of the transfer of title) by delivery to a carrier or other bailee for the buyer is inapplicable (and the conduct of the seller is merely an offer) where the seller acts otherwise than in conformity with the express or implied authority given by the buyer (as where there is a material variation as to kind, quality, or quantity of goods sent, or as to the time, route, or method of shipment, or as to directions or documents of title, or as to the packing and contracts of shipment).

No Partial Appropriation. Presumably under Rule 4 (as under Rule 2) title does not pass to the buyer upon the appropriation of instalments. There is no warrant for

the inference that he intends to become the owner of anything until there can be final appropriation of the whole, unless it can properly be inferred that title was to pass upon actual delivery of part of the goods (as probably by delivery into cars furnished by the buyer or a ship chartered by him).

F. O. B. and C. I. F. Contracts. In an F. O. B. contract the price includes all charges up to and including placing the goods in the hands of the carrier on the proper vessel or in the cars if the goods are carload lots (otherwise to the carrier at the proper station). Here title presumably passes when the goods are so delivered "free on board." In a C.I.F. contract the price covers not only the cost of the goods at the point of shipment but their insurance and freight to the point of destination, freight and insurance being paid by the seller: the seller has fulfilled his obligation, and the buyer is bound to pay the agreed price (irrespective of the arrival of the goods) upon tender by the seller (as soon as possible after shipment) of the proper documents: viz., an invoice giving credit for freight not paid or a receipt for freight paid, a bill of lading in due form and showing proper compliance with the contract, and a proper insurance policy (or certificate) on customary terms for account of buyer, or for account of whom it may concern. Title passes to the buyer at the moment of delivery on board since the parties have manifested an intention that it shall, notwithstanding the fact that the seller has paid the freight to destination. Manifest intention always overrides the artificial rules for ascertaining intention.

Sale or Return (Rule 3 [1]). When goods are delivered to the buyer "on sale or return," or on other terms indicating an intention to make a present sale but to give the buyer an option to return the goods instead of paying the price, a (defeasible) title passes to the buyer on delivery; but he may revest the property in the seller by returning or tendering the goods within the time fixed in the contract, or if no time has been fixed, within a reason-

able time. The sale becomes absolute if the buyer makes performance of the condition subsequent impossible (as by reselling the goods), or if the goods are so injured (even by accident) that he cannot effectually perform it. (S sells B a horse "on sale or return." Without B's fault the horse dies. The tender of a dead horse would not revest the title in S.) Ordinarily, title revests in the seller upon a proper tender, irrespective of his acceptance.

Sales on Approval (Rule 3 [2]). Where goods are delivered to the buyer on approval or on trial or on satisfaction, or other similar terms, the property therein passes to the buyer:

(a) When he signifies his approval or acceptance to the seller or does any other act adopting the transaction.

(b) If he does not signify his approval or acceptance to the seller, but retains the goods without giving notice of rejection — then, if a time has been fixed for the return of the goods, on the expiration of such time — or, if no time has been fixed, on the expiration of a reasonable time. What is a reasonable time is a question of fact.

The buyer can prevent title passing even though the goods conform in every respect to the contract, but he may be liable in damages for breach of contract where no element of personal taste is involved ("satisfaction" being interpreted to mean that the buyer is satisfied if he should be satisfied).

SALE OF UNDIVIDED SHARE OF GOODS

There may be a contract to sell or a sale of an undivided share of goods. If the parties intend to effect a present sale, the buyer by force of the agreement becomes an owner in common with the owners of the remaining shares. The whole mass is then at the risk of the parties in proportion to their rights *in rem* therein. Such a case must not be confused with an agreement whereby the seller is to select and appropriate from a mass.

Fungible Goods. In case of fungible goods (of which any unit is from its nature or by mercantile usage treated

as the equivalent of any other unit — e. g., grain, cotton, oil, gasoline) there may be a sale of an undivided share of a specific mass, though the seller purports to sell and the buyer to buy a definite quantity of the goods in the mass, and though the quantity of the goods in the entire mass is undetermined. By such a sale the buyer becomes owner in common of such a share of the mass as the quantity bought bears to the quantity of the entire mass. If the mass contains less than the amount bought, the buyer becomes the owner of the whole mass and the seller is bound to make good the deficiency from similar goods unless a contrary intent appears. (Thus where P agreed to sell and D to buy not less than 1,600 bushels out of 2,300 in two cribs, P reserving the right to 200-300 bushels if he needed them and A being entitled to 500 bushels, it could be found that there was intent to transfer title to at least 1,600 bushels. Such case is to be distinguished from one where the seller is to select and appropriate to the buyer a portion from the mass [twenty cords of hard wood from a pile of several hundred cords of hard and soft mixed] so that presumably title does not pass until at least the separation is made, whereas if the mass is delivered to the buyer and he is to make the separation, title to the goods covered by the contract will pass to him at once before separation.)

DESTRUCTION OF GOODS SOLD OR CONTRACTED TO BE SOLD

Where the parties purport to sell specific goods, and the goods without the knowledge of the seller have wholly perished at the time when the agreement is made, the agreement is void. If they have perished in part (or wholly or in a material part have so deteriorated in quality as to be substantially changed in character), the buyer may at his option treat the sale (a) as avoided, or (b) as transferring the property in all of the existing goods or in so much thereof as have not deteriorated, and as binding the buyer to pay the full agreed price if the sale was indivisible or to pay the agreed price for the goods in which the property passes if the sale was divisible.

There are analogous rules in case of a contract to sell specific goods where subsequently (before the risk passes to the buyer and without any fault on the part of seller or buyer) the goods wholly perish, or part of the goods perish (or the whole or a material part of the goods so deteriorate in quality as to be substantially changed in character).

CHAPTER XVIII

TRANSFER OF TITLE AS AFFECTED BY DOCUMENTS OF TITLE

It has been stated that delivery to a carrier ordinarily constitutes appropriation, with two exceptions:

1. Where the contract to sell requires the seller to deliver the goods to the buyer or at a particular place, or to pay the freight or cost of transportation to the buyer or to a particular place, the property does not pass until the goods have been delivered to the buyer or have reached the place agreed upon; and

2. Where the seller, by the terms of the contract or appropriation, reserves the right of possession or property in the goods until certain conditions have been fulfilled.

The second exception concerns us here. Where shipment is made by carrier, by what means can the seller prevent the buyer from obtaining possession of the goods except on condition that the buyer pays the price, gives his note or trade acceptance, or otherwise performs his obligations in accordance with the contract? The answer to this question may turn on the *form* of the document of title (such as a bill of lading or warehouse receipt) issued by a carrier, warehouseman, or other bailee in a given case. Bills of lading (documents issued by carriers to shippers) are either "straight" (nonnegotiable) or "order" (negotiable). The Federal Bills of Lading Act is applicable to interstate shipments. Many states have adopted the Uniform Bills of Lading Act, which governs intrastate shipments. A warehouse receipt (issued by a warehouseman) undertakes the delivery of goods deposited. The Uniform Warehouse Receipts Act, as elsewhere noted, has been adopted in every state but New Hampshire. For convenience we consider bills of lading.

STRAIGHT BILL OF LADING

A straight bill is one in which it is stated that the goods are consigned or destined to a specified person, and which recites: the date of its issue, the name of the person from whom the goods have been received, the place where the goods have been received, the place to which the goods are to be transported, a statement that the goods received will be delivered to a specified person, a description of the goods or of the packages containing them, and the signature of the carrier. It may contain other terms or conditions not contrary to law or reducing the carrier's obligation of care below that which a reasonably careful man would exercise as to his own goods. A straight bill, then, is:

1. A receipt issued by the carrier for goods received; and

2. A transportation contract between the carrier and the shipper.

To obtain the goods from the carrier when they have reached their destination the consignee need only identify himself: he need not surrender to the carrier the straight bill of lading which it issued to the shipper, or any copy thereof. Hence, a straight bill of lading does not control the possession of the goods, nor may it safely be dealt with as a symbol of the goods (a straight bill would not ordinarily be accepted as collateral security). In this respect it is like a nonnegotiable warehouse receipt (issued by a warehouseman to one who stores goods).

ORDER BILL OF LADING

An order bill of lading must embody the same recitals as a straight bill with this difference: it must state that the goods are consigned or destined *to the order of* a specified person (its negotiability is not affected by any provision that is nonnegotiable). Where goods are shipped under an order bill the carrier will refuse to deliver them unless the bill of lading (properly indorsed) is surrendered

to the carrier. In general, if a carrier delivers goods for which a negotiable bill has been issued, and fails to take up and cancel the bill, such carrier will be liable in damages to anyone who for value and in good faith purchases such bill, whether such purchaser acquired title to the bill before or after the delivery of the goods by the carrier, and notwithstanding that delivery was made to the person entitled thereto. Hence, an order bill is not merely a receipt for the goods and a transportation contract but also a symbol of the goods, controlling their possession and conveniently dealt with in place thereof. A negotiable document of title is customarily acceptable as collateral security.

Negotiable Documents of Title. A negotiable document of title controls possession, since the bailee will not deliver the goods without surrender thereof. Although paper negotiable in this sense (though not in that applicable to a bill of exchange or promissory note) is contractual in its origin, it is governed rather by the rules controlling transfers of property than by those governing the assignment of choses in action. The assignee of a chose in action is in the position of an original obligee with a direct right against the obligor. Negotiability, on the other hand, is, in its essence, the quality of assignability free from equities (defenses). The defenses cut off by A's negotiation of a negotiable document of title to D (a bona fide purchaser) are (1) that the negotiation was a breach of A's duty to P, (2) that P (owner of the document) was deprived of possession thereof by fraud, mistake, or duress (or by accident or conversion, under the Uniform Bills of Lading Act). Both the contract of the person issuing a negotiable document of title and the ownership of the goods are transferable as a negotiable instrument is negotiable. The form of the document indicates the ownership of the goods by naming the person to whom they are to be delivered. The fundamental distinction between negotiable instruments and negotiable documents of title is that the former (bills and notes) must contain an unconditional order or promise to pay generally and carry the general

credit of the parties thereto rather than the credit of a particular fund only, whereas a document of title can relate only to specified goods. The form in which a negotiable document is taken is regarded as a representation of title on which third persons may rely; hence the delivery of an indorsed (negotiable) document (or of one naming, as consignee entitled to delivery of the goods, the person to whose custody it is entrusted) is more than a delivery of the goods themselves. I, indorsee of a *negotiable* document of title representing goods in the possession of A (bailee), by delivery from B (owner, or one who could give title to a bona fide purchaser), prevails over trustee process (garnishment) or execution (subsequent to the issuance of such document) unless it is first surrendered or its negotiation enjoined. T, transferee for value of a *negotiable* document, may (in the absence of other agreement) compel the transferor to put thereon the indorsement essential for negotiation, with like protection as from that time. But the rights of T, transferee of a *nonnegotiable* document, may be defeated by attachment or execution by a creditor of the transferor (or by notification to A [by the transferor or by a subsequent purchaser from him] of a later sale of the goods by the transferor).

1. Forged Document. A forged document cannot transfer title or impose liability on the bailee who supposedly issued it.

2. "Spent" Document. Not even one to whom a negotiable document of title has been negotiated (P) can acquire thereby as against D (carrier or warehouseman) a right *in rem* to any goods if A (consignor or depositor) had no actual or ostensible title thereto (D's issuance of a document acknowledging receipt from A does not warrant A's title), or if (prior to the negotiation to P) the goods have been destroyed or delivered by D to a person then entitled to possession thereof; the same is true if D issued the document without receiving any goods. (P, holder of negotiable bills of lading as security for drafts accepted by A [drawee, who was thereupon entitled to receive the documents], cannot recover thereon from D [carrier], who delivered the goods to A without taking up the documents. But had P been a rightful holder for value without notice of the delivery, he could have recovered on his right *in personam.*)

3. **Documents Issued When No Goods Were Received.** The Uniform Bills of Lading Act provides that if the carrier's agent (whose actual or apparent authority includes the issuance of bills of lading where goods were actually received) fraudulently issues **a bill when in fact there are no goods behind it, the carrier will**

be liable: (1) to the consignee named in a nonnegotiable bill, or (2) to the holder of a negotiable bill who has in good faith given value therefor relying on the description therein. The measure of such liability would be the damages caused by the nonreceipt by the carrier of all or part of the goods or their failure to correspond with the description thereof in the bill at the time of its issue. Under the Federal Bills of Lading Act, however, the carrier will not be liable unless its agent had authority to receive the goods as well as authority to issue interstate bills of lading.

4. **Indorser Not a Guarantor.** Whereas the indorsement (and delivery) of a negotiable instrument is both a conveyance thereof and a contract to pay it if the requirements of diligence (presentment and notice) are met, the indorsement of a document of title is merely a conveyance and does not make the indorser liable for default or failure of the bailee issuing the document, or for default or failure of prior indorsers to fulfill their respective obligations.

5. **Warranties on Sale of Document.** A person who for value negotiates or transfers a document of title by indorsement or delivery, including one who assigns for value a claim secured by a document of title, unless a contrary intention appears, warrants:

(a) That the document is genuine;

(b) That he has a legal right to negotiate or transfer it;

(c) That he has knowledge of no fact which would impair the validity or worth of the document; and

(d) That he has a right to transfer the title to the goods and that the goods are merchantable or fit for a particular purpose, whenever such warranties would have been implied if the contract of the parties had been to transfer without a document of title the goods represented thereby.

One purchasing a draft with bill of lading attached (D) is not liable to the drawee paying the draft (P) for a breach of contract or warranty as to the goods by the seller-drawer, since D neither sells nor makes any representations as to the draft or bill of lading. The same result follows if the bill of lading is a forgery.

HOW THE SELLER MAY RETAIN CONTROL AFTER SHIPMENT

We are now in a position to return to the question posed at the beginning of this chapter: Where shipment is made by carrier, by what means can the seller prevent the buyer from obtaining possession of the goods unless the buyer either pays the price or otherwise performs his obligation under the contract? Four methods may be noted.

C. O. D. Shipment. If the sale is C.O.D., the buyer must pay for the goods before he can obtain possession. Title may or may not have passed to the buyer on shipment, or even before shipment. The law states merely that

C.O.D. terms do not *prevent* title from passing to the buyer on delivery to the carrier.

Straight Bill Consigned to Seller or Seller's Agent. The seller (S) may reserve title to the goods by means of a straight *bill of lading* wherein he (or his agent) is consignee. If he consigns the goods by straight bill to a third person (A) in accordance with B's contract or order, and A discounts, pays, or accepts S's draft, S's interest in the transaction is at an end (except as to his contingent liability as drawer of the draft) and A holds the legal title as security (the beneficial property interest being now in B), whereas if A neither discounted a draft nor made advances nor incurred a liability to S on the faith of the shipment, he is merely S's agent and the security title is held by A for the benefit of S.

Buyer's Order Bill. While *title* passes to the buyer if (in accordance with the contract or order) the goods are shipped by straight or order bill of lading wherein the buyer or his agent is named as consignee, the seller may reserve a right to the possession of the goods by retaining possession of a negotiable bill of lading wherein the buyer is consignee. He may send the bill of lading with draft attached to his agent or to a bank at the point of destination, with instructions to deliver the *bill of* lading only on condition that the draft is honored—that is to say, paid (if payable on demand or not more than three days thereafter) or accepted.

Sending Bill Direct to Buyer. Where the seller sends the bill of lading with draft attached direct to the buyer for payment or acceptance, the buyer must not use the bill until he honors the draft, the inference of concurrent conditions being drawn from the fact that the bill and draft were sent through the same channels (an inference which should not be drawn where the bill and draft are sent through different channels). The Uniform Bills of Lading Act[1] provides in substance that (unless a different intention on the part of the seller appears) it may be assumed that: (1) if the draft is *payable on demand* or presentation or at sight (or not more than three days thereafter), the seller intended to require payment of the draft before the buyer should be entitled to use the bill of lading; or (2) if the draft is *payable on time*

1 Enacted in 29 states. The Uniform Massachusetts Receipts Act has been adopted by every state except New Hampshire.

(extending beyond three days after demand, presentation, or sight), the seller intended to require acceptance, but not payment, of the draft before the buyer should be entitled to use the bill of lading. To put it shortly: a demand draft must be honored by payment whereas a time draft may be honored by acceptance. However, this method of sending the bill of lading with draft attached direct to the buyer involves the risk that an unscrupulous buyer, although not honoring the draft, may detach the bill of lading and negotiate it to a bona fide purchaser for value. Even a bona fide purchaser of the goods (as distinguished from the bill of lading) from the buyer would be protected under the Sales Act, although the buyer himself could obtain no rights whatsoever by the wrongful use of the bill of lading.

Seller's Order Bill. The seller may ship under a negotiable bill of lading to his own order. Assuming that the terms of the sale are F. O. B. shipping point, do the parties intend that title shall pass to the buyer on shipment in view of the fact that the goods are consigned to the seller's order? Here it is necessary to make a distinction between general property (beneficial ownership) and special property (legal or security title). The general property may pass to the buyer on shipment, and, accordingly, risk of loss will be on the buyer during transit. But if the general property passes to the buyer on shipment, the form of the bill of lading (by which the goods are consigned to the seller's order) is effective to reserve in the seller the special property (security title) in the goods *solely for the purpose of securing performance by the buyer of his obligations under the contract*. The seller's order bill has one advantage over the buyer's order bill with draft attached. A seller's order bill is immediately available as security to a seller who wishes to discount his draft on the buyer. The seller need merely indorse the bill of lading which runs to his own order. If the bill runs to the buyer's order it cannot be used as security to support a discount as the buyer's indorsement would be necessary in order to negotiate the document to the discounting bank.

Chapter XIX

OTHER INCIDENTS OF THE CONTRACT OF SALE

SALE BY ONE NOT HAVING TITLE

As to money and negotiable instruments payable to bearer, mere possession is title — so that while the legal title of a thief or a finder is defeasible by the true owner, the latter cannot regain the property from a bona fide purchaser. As to other property, no one but the owner can give title. One with no title at all (a thief or a finder) can transfer none, even to a person paying value in good faith and without actual or constructive notice, in the absence of estoppel (where there has been such action by B, in proper reliance upon a representation or statement by A [the owner] that B cannot withdraw without damage). Even where stolen goods are sold in the open market, the owner can always recover them (in England and Canada, however, the bona fide purchaser is protected under the doctrine of "market overt"). Assume, however, that B obtains goods from A by fraud. B's title is voidable at the instance of A. But if (before A so avoids B's title) B sells the goods to C (a bona fide purchaser for value), C acquires good title. Hence, the distinction between a person not the owner and a person having voidable title is important with reference to the rights of third persons who have acquired the goods.

Estoppel. Estoppel may grow out of apparent ownership or apparent authority, each usually characterized by B's possession of the goods for certain purposes with A's permission. The mere fact that B habitually sells such goods, or that A has given B (entrusted with possession) authority to exhibit them to obtain offers for them, may not by itself justify the finding of an estoppel (one who buys

salesman's samples on the salesman's representations that he is the owner is not protected); but the result may be different if A gives B possession coupled with indicia of title (allowing an agent or other person to have a document of title issued in his own name, or to have his name appear on property really belonging to A) or with power of sale.

1. **Factor's Acts.** Factor's Acts (in effect in at least ten states) are designed to protect third persons who (under specified conditions) deal with an agent believing him to be the owner of goods. Thus P may deliver goods to A for sale or as security, or P may entrust A with documentary evidence of title thereto. Assume that T (believing A to be the owner of the goods) contracts with A for their sale or disposition. A ships the goods to T, T having no notice by the bill of lading or otherwise that A is not the owner. Assume, further, that T has made advances to A against the goods or obligated himself in writing on the faith of A's ownership. Factor's Acts provide that before P can recover the goods, he must indemnify T. (Similarly, where P delivers goods to A for sale, and A, representing himself to be the owner, pledges the goods with the T bank to secure a personal loan: in order to recover the goods, P must indemnify the T bank.) The courts are not in accord either as to who is an "agent" within the meaning of the various Factor's Acts or as to whether or not one obtaining goods by fraud is "entrusted with possession" thereof.

2. **Conditional Sales.** At common law it is generally held that a conditional sale creates no estoppel as against the conditional seller, but this transaction is, in most jurisdictions, within recording statutes, intended to give notice of the seller's title and to invalidate it as to third persons (without notice of the true situation when they agreed to buy) unless the contract is in writing and is recorded. On principle, a conditional seller (or a chattel mortgagee) should not be able to reclaim the goods from a bona fide purchaser in the ordinary course of business from a conditional vendee or chattel mortgagor who is a dealer in such goods and who (by the terms of the conditional sale or chattel mortgage) is authorized to put the goods in stock (or otherwise make them apparently his own), notwithstanding the fact that the conditional sale or chattel mortgage has been properly recorded. One who buys from a dealer should not be expected to search the record for encumbrances. This principle finds expression in the Uniform Trust Receipts Act (enacted in five states, including New York), which under such circumstances, makes the authority given the dealer to exhibit the goods tantamount to an authority to sell; recent statutes in New York similarly protect one who buys a mortgaged automobile from a dealer, where the purchaser took in the ordinary course of business and without actual notice of the recorded mortgage. The rights of the conditional seller and of the conditional buyer are alike assignable (by sale or mortgage). The risks of loss and gain are upon the buyer.

3. **Lease of Chattel.** A lease, as distinguished from a conditional sale, contemplates merely use for a limited time (without change of ownership) followed by the return of the property to

the lessor; but where the "rent" nearly or quite pays the price, the transaction is in law a conditional sale whatever the particular name given to it by the parties, and, accordingly, within the recording laws.

4. **Consignment.** In case of a consignment (as distinguished from a conditional sale) the consignor's rights in the goods remaining unsold should not be affected either by the consignee's guaranteeing payment for any goods sold by him (a *del credere* agent) or by the consignee's being authorized to make himself a debtor when he sells the goods.

CASH SALE

A cash sale (where the intent is to exchange the goods for the price immediately upon making the bargain, as in a sale over the counter — where the transfer of title and possession and the payment of the price are concurrent) is to be distinguished from both:

1. A conditional sale (where, so long as he is not in default, the buyer has a right to possession before payment in full); and

2. An absolute sale (where title presumably passes as soon as there is an agreement on the terms of the bargain and as soon as the goods are in a deliverable state, but where — nothing being said about the time of payment — there is presumably no intention to extend credit); here the parties intend that possession is to be given only upon payment of the price (thus the seller is protected by having a lien and the buyer by having the legal title).

In so-called "cash sales" or "terms cash" transactions, contemplating a short period of credit (the buyer having the right in the interval to deal with the goods or even to resell them), the transfer of title should not be held to be deferred until payment of the price. A sale conditional on the buyer's giving a negotiable instrument for the price should be construed as a transfer of title subject to the condition precedent of performance by the buyer (rather than as a transfer of title with a lien in favor of the seller), whereas in a C.O.D. sale transfer of title is not ordinarily deferred until payment of the price. Assume that S is the original seller, B the buyer, and C a purchaser from B. If (as between S and B) title is not to pass until payment, C

gets no title (unless the Factor's Act or some similar statute applies) even though B has possession and makes delivery. However, C does get title if S has waived the benefit of the condition and assented to the transfer of title to B. Such waiver may be implied by S's voluntary parting with possession with intent that B use the goods as his own, or for a purpose other than special or temporary, and in a manner inconsistent with a cash sale. Where the buyer, in a cash sale, gives a worthless check for the price, the seller should be held to have assented to the transfer of title to the goods, though his assent may have been procured by fraud. (The condition in conditional payment by check has no reference to the ownership of the property exchanged therefor.) If the check is dishonored, the seller should have the right to resort to the debt for which the instrument was given, but S should have no more right to regain the goods from C (a bona fide purchaser from B, the original buyer) than if B had obtained the goods in exchange for a stolen chattel. Yet the New York courts hold that where B obtains the goods in a cash sale, giving a worthless check for the price, no title at all passes to B, and consequently S is permitted to recover the goods from C (the bona fide purchaser from B). Other courts have (equally illogically) allowed S to hold C in tort for conversion.

RETENTION OF POSSESSION BY SELLER

"Where a person having sold goods continues in possession thereof, or of negotiable documents of title thereto, the delivery or transfer by such person, or by an agent acting for him, of the goods or documents of title under any sale, pledge, or other disposition thereof, to any person receiving and paying value for the same in good faith and without notice of the previous sale, shall have the same effect as if the person making the delivery or transfer were expressly authorized by the owner of the goods to make the same. Where a person having sold goods continues in possession thereof, or of negotiable documents of title thereto, and such retention of possession is fraudulent in fact or is deemed fraudulent under any rule of law, a creditor of the

seller may treat the sale as void."[1] Delivery of possession at the time of the sale is thus necessary in a conveyance of chattels: (1) in order to make a title indefeasible against subsequent buyers (if the same goods are sold to two different persons by conveyances equally valid, the one first lawfully getting possession can hold them), and (2) in order to make the title indefeasible against the seller's creditors (if, and in so far as, retention of possession was, under the applicable state law, within statutes against fraudulent conveyances, such as 13 Eliz. c. 5 of 1571).

DELIVERY AND PAYMENT

The obligations of the seller to deliver and of the buyer to pay are mutually dependent (unless the contrary intention appears): where no time is fixed by the contract for performance by either, where the time for performance by one party only is fixed, or where one party is to perform in part in advance of the other (the remaining obligations being concurrent). Where the obligations are concurrent, neither party can maintain suit against the other without manifesting that he is ready and willing to perform by himself and without tendering performance (his tender may be made conditional on simultaneous performance by the other party). In the absence of other agreement, the buyer's obligation to pay for goods shipped in conformity with a contract or order matures (where no time is expressly fixed) only after a reasonable opportunity to inspect them at the place of destination (title, and therefore risk of loss ordinarily passing on shipment). If before delivery (or before inspection to be made at the place of delivery) goods (title to which has passed) are destroyed without the seller's fault, the risk of loss is on the buyer, even though time for payment of the price (in consideration of the transfer of title) was expressed to be upon, or at a fixed period after such delivery (or inspection thereupon).

Goods in Possession of Third Party. Where the goods are in possession of a third person (X), a delivery

---

1 Sales Act, Secs. 25, 26.

sufficient to satisfy the seller's duty to put the buyer in possession includes unqualified acknowledgment by X to the buyer that he holds the goods on behalf of the latter (if they are represented by a nonnegotiable document of title), whereas a delivery necessary to protect the buyer against all third persons (such as subsequent purchasers, or creditors of the seller) requires merely notice (by either seller or buyer) to X of the buyer's rights — whereupon (regardless of his assent to the transfer) X becomes bailee for the latter by operation of law.

Divisible Contract. In a "divisible" or "severable" contract each of the parties manifests a single assent to all the promises constituting one obligation, which admits of apportionment, the consideration on either side to correspond with the consideration on the other; a portion of the price to be paid by B (buyer) is (expressly or impliedly) allocated as the agreed exchange payable for a portion of the performance rendered by S (seller). Thus as S performs each of the successive parts to be paid for separately (although they were to be used together as parts of one completed whole), a debt therefor immediately accrues as against B and is recoverable notwithstanding a subsequent breach by S.[2]

If either party to a bilateral instalment contract has committed (or manifested an intention to commit) a material breach, the other party should be excused from the obligation of further performance, but his acceptance of defective performance thereafter with knowledge of the facts (or of further performance with knowledge of the breach) is an election to go on with the contract (not necessarily destroying a right to recover damages for the breach). The obligation of the innocent party thus depends on the materiality

2 *Section 45 — (Delivery in Instalments).* Where there is a contract to sell goods to be delivered by stated instalments, which are to be separately paid for, and the seller makes defective deliveries in respect of one or more instalments, or the buyer neglects or refuses to take delivery of or pay for one or more instalments, it depends in each case on the terms of the contract and the circumstances of the case, whether the breach of contract is so material as to justify the injured party in refusing to proceed further and suing for damages for breach of the entire contract, or whether the breach is severable, giving rise to a claim for compensation, but not to a right to treat the whole contract as broken.

of the breach; it is generally held sufficiently material to excuse the other party if there has been failure to deliver, or to accept or pay for, an instalment or a defect in the quality of an instalment. Since mutual debts do not cancel at common law, there is no broad rule that a buyer who has received an instalment under a divisible contract may rightly refuse to pay the price therefor because of the seller's actual or anticipated breach as to another instalment.

Letter of Credit. The ordinary type of letter of credit used in commerce is a promise upon strict terms by the financing bank, at the request of its customer, to pay to the seller or to his bank a specified amount on being furnished (within a designated time) with the specified shipping and other documents. It need not be in any particular form. It is irrevocable after issuance (unless the contrary is stated), perhaps on the theory that consideration for the bank's promise not to revoke is to be found in the customer's promise of reimbursement and of a commission.

Buyer's Right of Inspection. The right of inspection by the buyer may be either (1) *a condition precedent* to his obligation to take the goods (a right to see the goods in order to determine whether he *will* become the owner), or to his obligation to pay the price (a right to see the goods in order, before payment, to determine whether he *has* become the owner), or (2) *a condition subsequent* whose occurrence gives him the right to return the goods after title has passed and the price has been paid without an opportunity to inspect (or where inspection of goods in the buyer's possession is deferred for his convenience). Where the agreement relates to specific goods in a deliverable condition, or where the seller has appropriated goods to the buyer in conformity with the contract or order, inspection by the buyer (in order to determine before payment whether he *has* become the owner) is manifestly not a condition precedent to the transfer of title. On the other hand, where title is not to pass until delivery directly from seller to buyer, assent by the latter to take the goods is an essential part of delivery (that is to say, assent by the buyer to be-

come the owner of the goods is such a condition precedent) and mere surrender of the goods by the seller at a place where they will be in the buyer's control (or even the buyer's taking them into his physical control) should not effect a transfer of title until the completion or waiver of his examination (to decide whether he *will* become the owner). Thus if the buyer receives the goods at his place of business (waiving his preliminary right of examination) title passes subject to a "condition subsequent"—the buyer may revest title in the seller by rescission if, after a timely examination, the goods are found to be defective. Even a wrongful rejection (though a breach of contract) will prevent title passing where (under the contract) it is not to pass until delivery.

Acceptance. Acceptance by the buyer is his manifestation of assent to become the owner of specified goods offered by the seller (aside from the Statute of Frauds he may accept in advance such goods as the seller may appropriate). It does not necessarily imply that he may not reject the goods (notwithstanding that title has passed to him) as upon the occurrence of a condition subsequent, if inspection shows that they are not in conformity with the contract (where the bargain relates to specific goods and there is no opportunity to inspect, where testing or trial is necessary, or where goods are sold by description). Nor does it *per se* discharge the seller from liability for breach of any promise or warranty of which the buyer gives notice within a reasonable time after he should have known of it. Even payment in full does not conclusively establish that the goods comply with the contract or are taken in complete performance thereof. The buyer may accept a portion of the goods (correct in quality) without accepting the (defective) remainder if the price of the part taken can be determined by computation. Upon tender a promisee may in general refuse to perform without specifying any particular ground (and insisting upon any available ground). However, a refusal of tender or demand for one specific reason should preclude the later assertion of other (and es-

pecially technical) reasons readily remediable when the earlier refusal was made, on the ground that the promisee by specifying a particular reason has prejudiced or misled the obligor and so is estopped. A buyer having refused to take title because the goods are not those called for by the contract, and having notified the seller to remove the rejected goods, may, if necessary, resell the goods for account of the seller.

Chapter XX

RIGHTS OF THE PARTIES

THE SELLER'S RIGHTS

For purposes of convenience the Act treats separately of the "Rights of the Unpaid Seller against the Goods" and the "Remedies of the Seller" against the buyer. The two are often combined in practice. Thus, if the buyer wrongfully rejects the goods, the seller may resell the goods and (if such resale was properly made) sue the buyer to recover any deficiency. Thus, resale of the goods is combined with an action for damages. It should be remembered, therefore, that the separate enumeration of rights and remedies does not imply that each is necessarily exclusive of all others. The seller of goods is deemed to be an unpaid seller within the meaning of the Act:

(a) When the whole of the price has not been paid or tendered.

(b) When a bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has been broken by reason of the dishonor of the instrument, the insolvency of the buyer, or otherwise.

Unpaid Seller's Lien. The unpaid seller of goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases, namely:

(a) Where the goods have been sold without any stipulation as to credit (and the agreement does not bind the seller to transfer possession to the buyer unless the buyer at the same time makes payment);

(b) Where the goods have been sold on credit, but the term of credit has expired (the buyer not having taken possession during the credit period);

(c) Where (even before the time for payment has arrived) the buyer becomes insolvent. (A person is insolvent within the meaning of the Uniform Sales Act who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due, whether he has committed an act of bankruptcy or not, and whether he is insolvent within the meaning of the Federal Bankruptcy Law or not.)

The seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer. If title has not passed to the buyer, the seller cannot be said to have a lien (on his own goods). But he does have, in addition to his other remedies, a right to withhold delivery — similar to and coextensive with the rights of lien and stoppage *in transitu* that the seller has where the property has passed to the buyer. Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien (for the unpaid portion of the entire price) on the remainder, unless such part delivery has been made under such circumstances as to show an intent to waive the lien or right of retention. The lien is lost (a) when the seller delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the property in the goods or the right to the possession thereof; (b) when the buyer or his agent lawfully obtains possession of the goods, having thus both title and possession; (c) by waiver (as by asserting a right inconsistent therewith or on grounds independent thereof or by conversion, attachment, or assent to a resale). But the lien is not lost merely because the seller has obtained a judgment for the price of the goods.

Stoppage in Transit. When the buyer of goods (having title) is or becomes insolvent, the unpaid seller who has parted with the possession of the goods has the right of stopping them *in transitu* — that is to say, he may resume

possession of the goods at any time while they are in transit, and he will then become entitled to the same rights in regard to the goods that he would have had if he had never parted with the possession.

To exercise the right of stoppage in transit, the seller must notify either:

1. The person who has immediate custody of the goods, or

2. The principal (whose servant has custody of the goods), provided such notice is given at such a time and under such circumstances that the principal, using reasonable diligence, may transmit it to his servant in time to prevent delivery to the consignee.

When the Transit Ends. The transit is broken (ends) by delivery to the buyer at destination, or even by the buyer's intercepting the goods at some intermediate point. Goods are no longer in transit:

(a) If, after the arrival of the goods at the appointed destination, the carrier or other bailee acknowledges to the buyer or his agent that he holds the goods on his behalf and continues in possession of them as bailee for the buyer or his agent; and it is immaterial that a further destination for the goods may have been indicated by the buyer; or

(b) If the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent in that behalf.

If the goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of the particular case whether they are in the possession of the master as a carrier or as agent of the buyer.

Some courts distinguish between diversion and reshipment, holding that, if S in Chicago consigns goods to B in New York City and B diverts them to Albany *before* they reach New York, this does not break the transit; whereas, if, the goods reach New York and B *then* instructs the carrier to reship them to Albany, this is a case of reshipment which does not revive the transit broken when the carrier in New York notified B it was holding goods for his account.

In many cases goods are shipped by land and water, necessitating reloading and temporary storage at intermediate points. At such points the goods, while physically at rest, are nevertheless "in transit." Transshipment and storage are incidents—links in the chain of transportation.

Neither the unlimited power of the seller to reclaim or retain goods (even though retention is a breach of contract) where title has not passed from him, nor rescission and recovery by the seller for fraud (before the goods have

reached a bona fide purchaser) is properly called stoppage in transit. A seller, knowing of the buyer's insolvency at the time of the sale, cannot subsequently stop the goods in transit. The seller's right to stop is paramount to any lien on the goods claimed by third persons against the buyer; a levy by creditors of the buyer cannot defeat the right of subsequent stoppage. While the lien of the seller (or his right to stop in transit) is limited by the fact that a negotiable document of title (operating as delivery of the goods when indorsed) is outstanding, the transfer of a nonnegotiable document (even if indorsed for value) is not in legal effect a delivery of the goods and so does not affect those rights of the seller with reference to the rights of one advancing money to the buyer on the faith thereof or (where the seller has not consented to the subsale) of a subpurchaser. The latter is not protected by a transfer of anything less than title plus a document having the legal effect of a delivery of the goods.

Resale. If the goods are perishable, if the right of resale on default was expressly reserved, or if the buyer is in default in payment of the price for an unreasonable time, the unpaid seller (having a lien or having stopped the goods in transit) has the right to resell the goods with no further liability on the original contract to sell or the sale — conferring thereby a good title as against the original buyer. The buyer is liable for any deficiency but is *not* entitled to any surplus arising from such resale (even though title has passed and the seller, seemingly, occupies a position analogous to that of a mortgagee or pledgee who sells the security to satisfy the debt but must account to the mortgagor or pledgor for any surplus). The seller is not required to give the buyer notice of his intention to resell the goods; but the giving of, or failure to give, such notice is admissible upon the issue of the buyer's having been in default for an "unreasonable time" (if that is the basis of the resale). The seller can avoid any difficulty on this score by inserting in the contract of sale a provision giving him the right to resell immediately on the buyer's default. The

seller is bound to exercise reasonable care and judgment in making a resale, and subject to this requirement may make a resale either by public or private sale. If the resale is made before title has passed, the seller has at least as great rights as if it were made thereafter; and no distinction has been observed except that in the former case (the purpose of the resale being merely to determine the seller's damages) it should be at about the time when performance was due in order to determine the then market price, whereas in the latter there is no such requirement of a prompt sale. The resale may even be during the period of agreed credit if the buyer has repudiated the contract or manifested his inability to perform. In reselling, the seller acts (by virtue of a power given by law) primarily to protect his own interests and is not to be deemed the buyer's agent. If the buyer has been guilty of a material breach, he is within the general rule which does not permit one (being himself in default and refusing to perform, whereas the other party is ready and willing to proceed) to recover what he has previously advanced or done. A prior judgment for the price is not necessarily inconsistent with resale under this section (since the remedies are several and alternative) although the buyer should be credited with the proceeds in reduction of his debt.

Rescission of the Transfer of Title. Where the unpaid seller (having a right of lien or having stopped the goods in transit) expressly reserves the right to rescind the transfer of title in case of the buyer's default, or where the buyer has been in default in payment of the price for more than a reasonable time, the seller may rescind and thereafter treat the goods as his own, holding the buyer liable in damages (measured by the difference between the contract price and the fair market value of the goods at the time and place of delivery as fixed by the contract). In order to rescind the transfer of title the seller must either give the buyer notice of his intention to rescind or perform some overt act (which need not be communicated to the buyer, although giving or failure to give notice of inten-

tion to rescind is admissible on the issue of default for an unreasonable time) manifesting an intention to rescind (seller, after obtaining possession of the goods from the carrier, mingled them with his own, giving no notice to buyer that the goods were being held for him or that the goods were to be resold for the buyer's credit). Rescission of the transfer of title (as distinguished from rescission of the contract or sale — as to which see p. 131 *infra*) does not terminate the buyer's liability for damages.

REMEDIES OF THE SELLER ON THE CONTRACT

Action for the Price. In general, the seller is not entitled to a judgment for the price unless title has passed. Even though the buyer's rejection of the goods be wholly unjustifiable, the seller (where the buyer's refusal to accept is effective to prevent title passing) cannot force the goods down his throat, but (under the Act) he has a remedy in damages. There are, however, two situations in which the seller may sue for the price even though title has not passed, viz:

1. Where (by the terms of the contract) the price is payable on a day certain, irrespective of delivery or of transfer of title (and even though the goods have not been appropriated to the contract);

2. Where the goods cannot be resold readily for a reasonable price (unless the seller has proceeded with the contract *after* the buyer notified him of repudiation or countermand while labor and expense of material amount were still necessary on the seller's part to enable him to perform). (S agreed to sell and deliver to B 5,000 Xmas cards, title to pass to B on delivery. After S had completed the cards and at a time when the market for such cards was over until the following year, B repudiated the contract. S is not required to sell the cards for the best price obtainable. S may notify B that the cards are thereafter held by S as bailee for B. S may treat the goods as B's and maintain an action for the price.)

A seller who has reserved a security title (general property in the goods — so that risk of loss has passed to the buyer) has been permitted to sue for the price.

Action for Damages. Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may maintain an action against him for damages for nonacceptance. The measure of damages is estimated loss directly and naturally resulting, in the ordinary course of events, from the buyer's breach of contract. If there is an available market for the goods in question, the measure of damages (in the absence of special circumstances showing damage of a greater amount) is the difference between the contract price and the market or current price at the time when the goods ought to have been accepted, or, if no time was fixed for acceptance, then at the time of the refusal to accept. A seller completing after repudiation or countermand (see p. 130) can recover no greater damages than as if he had stopped thereupon, but his profit estimated as upon completion may be considered. This rule should be interpreted in accordance with its purpose: to mitigate the seller's damages. Consequently, if the cost of completion is relatively insignificant as compared with the accretion in value incident to completion, some courts have held that the purpose of the rule would justify disregard by the seller of the buyer's instructions.

Rescission of the Contract of Sale. Where the goods have not been delivered to the buyer, and the buyer has repudiated the contract to sell or the sale, or has manifested his inability to perform his obligations thereunder, or has committed a material breach thereof, the seller may totally rescind the contract or the sale by giving notice of his election so to do to the buyer.

REMEDIES OF THE BUYER

For Conversion or Detention. Where property in the goods has passed to the buyer and the seller wrongfully neglects or refuses to deliver them, the buyer may main-

tain any action allowed by law to the owner of goods of similar kind which are wrongfully converted or withheld.

For Failure to Deliver. Where the property in the goods has not passed to the buyer and the seller wrongfully neglects or refuses to deliver them, the buyer may recover damages measured by the loss directly and naturally resulting, in the ordinary course of events, from the seller's breach of contract. Ordinarily the difference between contract and market price at the time they should have been delivered (or, if none were fixed, at the time of the seller's refusal to deliver) fixes the amount of damages.

For Specific Performance. The buyer may obtain specific performance of a contract to deliver specific or ascertained goods — that is, a court of equity has discretionary power to grant such relief. Ordinarily, however, equity will decree specific performance only with respect to unique and irreplaceable chattels (a rare painting, a statue, stock not listed on any exchange), deeming money damages to be adequate compensation in all cases where there is an available market for goods similar to those forming the subject matter of the contract.

For Breach of Warranty. Where there is a breach of warranty by the seller, the buyer may, at his election:

(a) Accept or keep the goods and set up against the seller the breach of warranty by way of recoupment in diminution or extinction of the price (but if, after acceptance of the goods, the buyer fails to give notice to the seller of the breach of any promise or warranty within a reasonable time after the buyer knows or ought to know of such breach, the seller will not be liable therefor).

(b) Accept or keep the goods and maintain an action against the seller for damages directly and naturally resulting, in the ordinary course of events, from the breach of warranty (provided timely notice of defect was given to the seller). In case of breach of warranty of quality, damages ordinarily amount to the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if answering to the warranty.

(c) Refuse to accept the goods *if the property therein has not passed,* and maintain an action against the seller for damages for the breach of warranty.

(d) Rescind the contract to sell or the sale and refuse to receive the goods (or if they have already been received, return them or offer to return them to the seller and recover the price or any part thereof which has been paid).

When the buyer has claimed and has been granted a remedy in any one of these ways, no other remedy will thereafter be granted.

Part IV: Agency

CHAPTER XXI

FORMATION OF AGENCY

Agency is a relationship resulting from an agreement (not necessarily a contract) that A (the agent) shall act on behalf of P (the principal) subject to P's control, and ordinarily it implies a power in A to contract with a third person (T) on behalf of P. It is this power to affect P's contractual relations with third persons that differentiates an agent from a servant. Servants, too, are subject to control of their masters; but a servant (S) has no power to bind his master by contracting with a third person (T). (The president of a corporation is an agent: the office boy is a servant.) The same person (A) may, it is clear, act for P as agent in one transaction and as servant in another.

CAPACITY OF P AND A

In general, whatever P can do by acting in person he can do through A. Courts differ as to whether the appointment of an agent by an infant principal is void or merely voidable, but agree that an infant may act as agent if he possesses the requisite physical and mental qualifications.

FORM OF APPOINTMENT

In general, there are no formal requirements governing the appointment of an agent. A's authority may be oral, written, or implied from circumstances. Note, however, that:

1. A contract of agency to continue for more than one year from the date of making is unenforceable unless in writing (Statute of Frauds).

2. Where P appoints A to execute a formal document which, in order to be effective, must be under seal, A's appointment must also be by an instrument under seal.

3. Where P appoints A to transfer an interest in real estate, A's authority (in most states) must be in writing signed by P. (A real estate broker is not within this rule where his authority [as is usual] is limited to finding prospective purchasers and does not extend to making a contract to pass title.)

ACTUAL AUTHORITY

Actual authority may be conferred by words (*express authority*), by conduct, or even by silence (*implied authority*) as where P (knowing that A is acting for him in circumstances where dissent would ordinarily be manifested) does not dissent. Actual authority (express or implied) includes authority to do acts incidental to the transaction or reasonably necessary to its accomplishment. (P instructs A to collect a bill: A has authority to give a receipt.)

Authority by Necessity. Unforeseen emergencies may arise in which it is impracticable for A to communicate with P and await instructions. Here A can bind P by such action as will prevent substantial loss to P. (A shipmaster can sell the cargo in an emergency, although ordinarily he has no authority to bind the owner of the goods by any disposition of them.)

APPARENT (OSTENSIBLE) AUTHORITY

P may create in A the appearance (at the same time withholding the reality) of authority. If, now, T deals with A, P is estopped to deny that A's actual authority is equal to A's ostensible authority on which T relied. (P writes T that A is authorized to sell certain store fixtures. P privately instructs A not to consummate the sale, but merely to obtain T's best offer. A gives T a bill of sale to the fixtures for $100. The sale is binding on P. A had ostensible, not actual, authority to make the sale.)

Estoppel by Course of Dealing. Ostensible authority

is another name for authority by estoppel. Estoppel to deny A's authority may be based on a course of dealing. (The T bank has cashed for A numerous checks payable to P's order and indorsed in P's name by A. P, knowing of the practice, has never objected to it. A indorses in P's name a check for $250, obtains the cash from the bank, and absconds. P cannot recover from the T bank. By sanctioning the practice P has held out A [to T] as having actual authority to indorse checks with his [P's] name.)

Ostensible Authority Incident to a Particular Position. If P puts A into a position wherein it is usual for the occupant to have particular authority anyone (T) having occasion to deal with A in that position is justified in assuming that A has such authority. Secret limitations on A's authority are ineffectual. (A, a general insurance agent, can effectively insure against risks contrary to express instructions of his principal, but within the scope of A's apparent [customary] authority, if the assured is ignorant of the limitations on A's authority. Thus, it has been held that P is bound on policies written by A [a general insurance agent] covering: property of an insolvent person; accident insurance, the assured being over 65 years of age; insurance on property of a person expressly named by P to A as a prohibited risk. *Similarly*: P instructs A [a commission merchant with ostensible authority to sell on credit] not to sell to X except for cash. A sells to X on credit. P is bound by the contract, but if X's account is uncollectible, A must make good the loss to P.) Where P puts A in charge of a business, A has ostensible authority to buy on credit or for cash.

RATIFICATION

P is not bound where A, lacking actual or apparent authority, acts on P's behalf. Yet P (having knowledge of all the material facts) may elect to affirm A's unauthorized action, thereby giving it the same effect as if P had originally authorized it. Such affirmance is ratification. P has this power wherever A discloses to T that he is acting on behalf of a principal even though A does not further identify P (by name). (Even where A purports to be acting for

himself, P can [in some states] ratify A's unauthorized act.) P's affirmance of A's unauthorized act may be manifested by any conduct showing consent thereto (receipt or retention of benefits by P with knowledge of the facts) or by P's failure to repudiate A's act after he learns of it. P cannot ratify A's act or contract in part, but only in its entirety. There is a conflict of authority as to whether T (by giving notice to P or A) can withdraw from the transaction at any time before P affirms. It seems clear that T, whose position is that of an offeror, should have such right of withdrawal; otherwise T cannot hold P, and yet T's hands are tied until P manifests his position.

P's affirmance is not effective if it takes place after T dies or becomes insane, or after the situation has so materially changed that it would be inequitable to subject T to liability if he elects to disaffirm. (A, acting for P, without authority obtains from T a policy of insurance on P's property. P cannot ratify the policy *after* a fire has occurred.)

ADOPTION

P cannot ratify A's act unless P was capable of contracting at the time of the transaction. A, a promoter, makes a contract on behalf of P, a corporation not yet in existence. When the P corporation is organized it can adopt (but not ratify) the contract. Such adoption is effective as of the date of adoption: it does not (as in the case of ratification) "relate back" to the date on which A made the contract. The distinction may be of importance in determining whether a contract is to be performed within one year from the date of its making (Statute of Frauds) or whether a cause of action, accruing on the date the contract was made is "outlawed" (Statute of Limitations).

INTERPRETATION OF AUTHORITY

Rules for the interpretation of contracts apply to the interpretation of actual and ostensible authority, which must be examined in the light of surrounding circumstances, the relationship of the parties, the nature of the business, and

trade usage. The scope of certain authorizations (actual or apparent) has been declared by judicial interpretation; viz:

1. *Authority to make a contract* does not include authority to alter, rescind, waive conditions, render or receive performance, assign or sue upon it (none of these acts is necessary or incidental to the making of the contract).

2. *Authority to "buy" or "sell,"* depending upon the circumstances, may mean:

(a) That A is to find a prospective seller or buyer with whom P may contract directly; or

(b) That A is to make a completed contract for purchase or sale; or

(c) That A is to accept or make a conveyance for P.

Generally an agent not entrusted with possession (of goods or documents of title) has authority only to solicit orders or to produce a buyer with whom the principal may deal. Authority to sell includes authority to make customary warranties and representations, but to sell only for cash unless a course of dealing justifies the inference that A had authority to sell on credit. Authority to buy is interpreted to mean only for money if P has supplied A with funds; otherwise, A can pledge P's credit on reasonable terms.

3. *Authority to take charge* of property includes authority to take reasonable measures appropriate thereto, including authority to protect it, to keep it in repair, to recover it if lost or stolen, and (if usual) to insure it.

4. *Authority to receive payment* means payment in money (not in checks, which are only conditional payment). Authority to receive negotiable instruments as payment, means instruments payable to P, and does not *per se* include authority to indorse (although an agent is often expressly authorized to indorse for deposit in an existing account of P). Authority to remit in a changed form (as after deducting a commission) would ordinarily indicate authority to indorse, in order that A may make such deduction. The agent should not deposit in his own name unless

(as is often true of a factor or collecting bank) he is authorized to become a debtor for the amount collected.

5. *Authority to borrow* is rarely inferred unless it is impossible for A to communicate with P and borrowing is indispensable to the continuance of the business or to prevent a very considerable loss.

6. *Authority to execute or to indorse negotiable paper* is ordinarily inferred only when indispensable to the accomplishment of the acts A is authorized to perform. Particularly rare is the situation in which A could bind P by an accommodation signature.

Agent's Authority to Appoint an Agent (Subagent of the Principal). Where P appoints A as his agent, A, by inference, has authority to appoint another (B) as agent for P whenever such authority is ordinarily incidental to A's duties or is customary under the circumstances. (P appoints A as manager of P's business. A hires B as bookkeeper. B is a subagent of P. P's right to control B is just as extensive and just as immediate as his right to control A: B is directly responsible to P for the proper performance of his duties.)

Delegation of Authority. Ordinarily P's selection of A as his agent is determined largely by the trust and confidence that P has in A. Accordingly A may not, in general, delegate his duties either to subagents or to employees. A may, however, delegate the performance of acts which are purely ministerial or mechanical. (P retains A, an attorney, to prosecute a claim. A can delegate to his law clerk certain preliminary tasks [legal research, briefing, interlocutory motions, court appearances, drawing pleadings] but A must conduct the trial of the case in person.)

A servant ordinarily has no authority to delegate, since the physical conduct of his services is subject to the principal's control (or right of control).

Chapter XXII

PRINCIPAL AND AGENT

DUTIES OF PRINCIPAL TO AGENT

The law (in the absence of express agreement) imposes upon the principal certain well-defined duties to his agent, among which we may note:

1. *Co-operation.* P must co-operate with A where A's compensation is contingent on results which can be accomplished only if the principal co-operates.

2. *Indemnification.* P must indemnify A for payments made or losses incurred as a result of authorized transactions.

3. *Compensation.* P must pay A the compensation agreed upon, or (if no compensation was specified) the reasonable value of A's services. (Where A is a relative of P, the service may be inferred to have been gratuitous, in the absence of an express provision.) In addition to compensation, A may be entitled to have work to perform where A's skill depends upon constant practice. Employment on a monthly or yearly salary does not of itself indicate that the employment is to continue for that period: such employment is terminable by either party at any time, unless other facts exist from which it may be inferred that employment for a definite period was agreed upon.

Real Estate Broker. Where P lists property for sale with A, a real estate broker, A's authority is not to make a contract for the sale of the property, but merely to find a prospective purchaser (T) who is ready, able, and willing to contract with P upon the terms stated in the listing. A earns his commission by producing T — whether or not T ever takes title to the property (unless, by express agree-

ment, A is to receive a commission only "when, as, and if" title passes).

If a broker is the effective cause of a transaction, he is entitled to the agreed compensation although the principal did not know the broker was instrumental in the negotiations and so made lower terms than he would otherwise have made. Where P lists real property for sale with A (a broker) P may also list such property with B, C, . . . N; and P may try to effect a sale through his own efforts.

Exclusive Authority to Sell. P's appointment of A as exclusive agent to sell specified property is not equivalent to giving A an exclusive power of sale; in the former case P may endeavor to sell through his own efforts, in the latter he may not so compete with A. But if P appoints A as exclusive agent to sell P's products in a specified territory, P may not compete with A in that territory.

Wrongful Termination of Agency. Where P wrongfully discharges A, A may:

1. Sue immediately after the breach (in most states) recovering judgment for prospective damages, or

2. Sue after the expiration of the contract period for actual damages. (P is entitled to credit for the amount earned by A between the date of discharge and date of termination of the contract. During this period A must seek to mitigate his damages by trying to find work of like character in the same locality.)

TORT LIABILITY OF PRINCIPAL TO AGENT OR SERVANT

P's tort liability to A is the same as to any third person except that P must warn A as to any unreasonable risk involved in the employment. Common law rules as to the tort liability of an employer to his employees have been rendered largely obsolete by federal and state Employers' Liability Acts (Workmen's Compensation Insurance). The statutes define hazardous employments, provide for medical attention to the injured worker, fix death benefits and compensation for various injuries or "accidents" arising out of

and in the course of the employment, and (in some states) fix compensation for occupational diseases. These statutes distribute the risk of injury over an entire industry, and do not condition the right to receive compensation on fault or negligence in the employer, or on freedom therefrom in the employee. Under the common law rules, on the other hand, an employee injured in the course of his employment could not hold his employer liable:

1. If the employer had not been negligent, or

2. If the employee had been negligent (contributory negligence), or

3. If the employee had been injured by the negligence of some other employee (the Fellow Servant Rule), or

4. If the injury had resulted from open and obvious risks of the business (*contractual* assumption of risk) and other risks *voluntarily* assumed by the employee.

DUTIES OF AGENT TO PRINCIPAL

The duties of the agent are fixed by the agreement between P and A, interpreted in the light of applicable circumstances and those standards of obedience and loyalty which the law has annexed to the principal-agent relationship.

Obedience. A (even though a gratuitous agent) must obey P's instructions, even if they are capricious or impracticable or motivated by P's desire to irk A (as where P assigns to A disagreeable tasks which are within the scope of A's duties). A may, however, disobey P's instructions where A is privileged to protect his own interests. (A, a factor, has a lien on P's goods in A's possession to the extent of all moneys advanced by A to P. P directs A to return the goods or sell them on credit. A is not bound to comply with P's orders until P has repaid all advances made by A.) A's disobedience (unless privileged) subjects him to liability in damages, and, if material, justifies P in terminating the agency.

Accounts and Deposits. A must keep and render ac-

counts of receipts and disbursements on P's behalf. Where A collects money for P, he should keep it separate from his own and deposit it in a special account in trust for P; otherwise A bears any loss resulting from the bank's failure.

Loyalty. The agent (whether paid or gratuitous) must act solely for the benefit of the principal in all matters connected with the agency, and take no unfair advantage in using what is acquired by him because of the opportunities afforded by his position. He must turn over to P any secret profit made by him in a transaction connected with his agency, or in the time which A is required to devote to P's business. (P employs A as a full-time salesman. Unknown to P, A agrees to carry a noncompetitive sideline for X. P is entitled to all commissions or compensation earned by A on sales of X's goods.) Loyalty to P demands that:

1. *A must not act as an adverse party.* (P authorizes A to buy specified goods. A must not sell P goods belonging to A: unless P consents, such sale is voidable, notwithstanding that the price was fair and that A could have done no better had he purchased the goods for P on the open market. Similarly, if P authorizes A to sell goods, A must not sell to himself. His duty [to get the highest price] here conflicts with his interest [to buy as cheaply as possible.])

2. *A must not act for an adverse party.* A cannot serve two masters — unless both consent, or unless he is a mere middleman or intermediary with no independent initiative. (P employs A to find a person interested in exchanging a farm for a city lot, and X employs A to find someone interested in exchanging a city lot for a farm. A is given no authority by P or X to fix terms or to make a contract. Although neither P nor X knows that A is employed by the other, A may accept a commission from each.) Where both principals consent to a dual agency, A must disclose to each all pertinent facts.

3. *A must not use or disclose confidential information* given by P. After the agency is terminated A is no longer under a duty to abstain from competition and may then use general information as to business methods and processes

and names of customers remembered (if not acquired in violation of his duty as agent), but he must still not injuriously use or disclose unique or confidential information entrusted to him only for P's use or acquired by A in violation of his duty. (A has no right to use mailing lists or a list of P's customers copied while in P's employ, but after A's employment has terminated he is under no duty to "wipe clean the slate of his memory.") One employed to do noninventive work (as distinguished from one employed to do experimental work for inventive purposes, or to achieve a specific result accomplished by the invention) is entitled to patents resulting from his invention (though growing out of work for which he was employed and with the employer's tools and facilities). He must act in the principal's name and not so receive or deal with the principal's things that they appear to be his or so mingle them with his own as to destroy their identity.

The foregoing principles apply also to servants.

CHAPTER XXIII

PRINCIPAL AND THIRD PARTY

CONTRACTS AND CONVEYANCES (P DISCLOSED)

P's Obligation where A's Acts Are Authorized. P is a party to and liable upon a contract made by A with T, where A discloses to T that he is acting on behalf of a principal (whether identified by name or not), and where the contract is within A's actual authority. T may enforce P's liability even if the contract is in writing and purports to be the contract of A except that:

1. In those jurisdictions which still accord to the seal its common law efficacy, P is not liable on an instrument under seal executed by A in his own name, in which instrument P is not named as covenantor or grantor, and

2. P is not liable on a negotiable instrument unless his name appears therein.

A memorandum signed by A in his own name satisfies the Statute of Frauds (if A is authorized) even though it fails to indicate P's existence or identity, and even though a statute may require A's authorization to be in writing.

P's Obligations where A's Acts Are Unauthorized. P's liability on unauthorized contracts (made by A on P's behalf) rests on estoppel or ratification. Unless A had ostensible authority to make the unauthorized contract, P will not be bound. Similarly, A's false representations (incidental to the making of a contract) impose liability on P. T (to whom such misrepresentations were made) having no notice of their falsity or of A's lack of authority may rescind the contract or have judgment against P in damages, provided A had actual or apparent authority to make

true representations concerning the subject matter. But P is not liable if T relies on A's misrepresentations as to the existence or extent of A's authority, unless:

1. P has invited T to deal with A on terms to be stated by A, or

2. P has appointed A as general agent with authority to make a contract or to issue documents (bills of lading, warehouse receipts, stock certificates) on the happening of an event or the existence of circumstances peculiarly within the agent's knowledge. (A, a freight agent of the P railroad, conspiring with X, wrongfully issues to X bills of lading for 60 barrels of beans which were never received for transportation. X draws a draft on the consignee and T discounts the draft with the bills of lading attached as security. In most courts T can hold P liable for damage sustained. A had been authorized to issue bills of lading only upon the actual receipt of property for transportation, but A alone would know whether property had in fact been received for transportation; hence A's representation as to this fact [if relied on by T] is binding upon P. A, it will be noted was a general, as distinguished from a special, agent; that is, he was authorized to issue not one, but an indefinite number of bills of lading, which involved continuity of service and authority to engage in not one, but several transactions of a specified character.)

If a general agent (A) is employed by the principal (P) in a position in which the occupant usually has authority to issue negotiable instruments (a partner in a trading partnership or cashier in a bank), the fact that A was unauthorized to issue the particular instrument sued on is no defense against a holder in due course. If P entrusts (but does not indorse) to A a negotiable instrument payable to the order of P, A does not have ostensible authority to collect or transfer the instrument merely because he has possession of it.

Obligations of Third Party (T). P can enforce the liability of T on a contract made with A (acting for P and within A's actual or ostensible authority), unless the con-

tract by its form or terms excludes P as a party or unless A deceives T as to the existence of P (a principal not fully disclosed). (P authorizes A to sell to T certain building material. A [knowing that T would not deal with P] represents that he [A] is acting for himself and denies the existence of P. T can rescind the contract.)

CONTRACTS AND CONVEYANCES (P UNDISCLOSED)

P's Obligations where A's Acts Are Authorized. P (although totally undisclosed) is bound by authorized contracts and conveyances made by A acting for P except on contracts under seal, negotiable instruments, and contracts which specifically exclude an undisclosed principal as a party thereto. Despite the parol evidence rule, P is liable on a written contract (with the exceptions noted) which purports to be the contract of A. P's liability for A's false representations is the same as where P is disclosed.

P's Obligations where A's Acts Are Unauthorized. P (totally undisclosed) is liable for acts of a general or managing agent usual or necessary in a transaction which he is authorized to conduct. (P employs A to manage a cigar stand owned by P, authorizing A to conduct the business in A's name, but forbidding him to buy cigars on credit. A buys cigars from T on credit. On learning of the agency T can hold P liable, as A's act was "within the authority usually confided to an agent of that character.") P (totally undisclosed) is not bound by any part of an entire contract containing terms beyond A's actual or ostensible authority, or by an act authorized but not done with intent to act in behalf of P (since here there is no reliance by T).

UNAUTHORIZED DISPOSITION OF CHATTELS. The mere fact that P entrusts a chattel to A's possession with neither indicia of ownership nor authority to deal therewith (as for storage, appraisal, exhibition, or repair) does not raise in A ostensible authority to sell or otherwise dispose of it. (T is not protected if he buys samples from A, a salesman, believing them to be A's property when, in fact, they belong to P.)

Nor is T protected if A (a special agent) having authority to deal with a chattel in his possession in a particular way, deals with it in another way. In a number of states [1] statutes protect the innocent purchaser or pledgee (T) from an agent or factor (A) who, entrusted by P with possession of documents of title or goods with authority to sell or pledge, exceeds his authority in contracting with T for their sale or disposition to T. (A, a factor, having in his possession P's goods which he is authorized to sell for P's account, pledges them to T as security for a personal loan. T acted in good faith and in the belief that A was the owner of the goods. At common law P could recover possession of the goods, but under Factor's Acts P must reimburse T for the amount advanced to A before P can recover them.) Quite apart from such legislation and on general principles of estoppel, if A is entrusted by P with possession of a document of title or chose in action (in such form that possession is commonly regarded as indicating a general power of disposition), P's interest may be cut off if A wrongfully transfers such document or instrument and it comes into the hands of T, a bona fide purchaser.

Settlement between P and A. P (whether disclosed or undisclosed) is discharged from liability to T if P has paid or settled with A in the erroneous belief (induced by T's conduct and not by A's misrepresentation) that A had paid or settled with T. (P authorizes A to buy goods on credit. A buys from T, A not disclosing that he is acting for P. After the credit period has expired T [at A's request] gives A a receipted bill for the goods, although T has not received payment. A exhibits this bill to P as evidence that he has made payment, and P thereupon pays A. T may not recover from P.)

T May Elect to Hold P or A Liable. Where P is totally undisclosed, T's election is irrevocable: (1) if (after disclosure of the agency) he proceeds to judgment against A with knowledge of the identity of P (a totally undisclosed

[1] California, Maine, Maryland, Massachusetts, Montana, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Dakota.

principal), or (2) if T proceeds to judgment against P (a totally undisclosed principal); but the statutes of each state must be consulted. Thus in New York, T may proceed to judgment against both P and A, but may, of course, obtain but one satisfaction.

Where P is disclosed or partially disclosed and A is a party to the contract, T's manifestation to A that he will look solely to P is irrevocable to the extent that A has changed his position in proper reliance thereon.

Obligations of Third Party (T). Where A contracts with T on behalf of P (who is totally undisclosed) P has all the remedies that would be open to him if A had disclosed the agency. This may be so notwithstanding a clause against assignment. P has such remedies even if the contract is within the Statute of Frauds, but not where

1. It is in the form of a sealed or negotiable instrument; or

2. The terms of the contract exclude liability to P or to any undisclosed principal (a contract for personal services, or one which involves some special skill of A, or confidence which T reposes in A).

Where P authorizes A to conceal his (P's) existence, T may set off against P any claim which (at the time the contract was made) T had against A and which T could set off against A if A sued on the contract. If P instructs A to contract in P's name, but A, in violation of P's instructions, deals with T in his own name, T may nevertheless possess the right of setoff where P entrusted A with the possession of chattels or otherwise misled T into extending credit to A. (The P bank advances money to A, an importer, to buy silk in China, P taking title to it as security. P delivers the silk to A under trust receipts to be sold by A for P. A, representing himself to be the owner, sells the silk to T for $5,000. At the time of the sale A owes T $600 on other transactions. P sues T for the price of the silk. T can set off against P the $600 claim against A. But if A had neither possession of the goods nor indicia of ownership, T would not have had this right of setoff, as the circum-

stances should then have put T on inquiry as to A's real status in the transaction.) T may rescind if he was induced to enter the contract by A's misrepresentation that he was not acting for P, with whom (as A or P knew) T would not have dealt.

P'S LIABILITY FOR TORTS OF SERVANTS

Independently of cases of actual or ostensible authority, A may have power—arising from the agency relationship—to bind P to T. Thus P is liable to a third person (T) for injuries caused by the tortious conduct of P's servant (A) within the scope of his employment or even outside the scope of such employment for consequences intended or proximately following his directions to A, for negligence in the employment of others, and for failure to perform a nondelegable duty. P's vicarious liability in general depends on his right to control the physical activities of A and direct in detail the manner, place, and time at which A does his work.

Independent Contractor. Where P contracts with X for a certain result, leaving X free to select the means and to determine the manner of performance, X is said to be an independent contractor — not a servant. Unlike a servant, he does not submit to the directions and control of P as to either the manner of performance or his physical movements. The importance of the distinction lies in the fact that P (except for injuries or damage caused by X's failure to take precautions against harmful consequences otherwise *necessarily* incidental to the performance of the contract) is not liable for injuries or damage caused by the tortious conduct of X (an independent contractor), because P has, in general, no right to exercise control over X's physical movements or operations. (X, a general contractor, agrees to build a house for P according to plans and specifications. P is entitled to demand a certain result, but not to direct the manner or performance by X. X is an independent contractor.) In determining whether X is a servant or an independent contractor one must consider:

(1) the extent of P's agreed control over details, (2) whether or not X is engaged in a distinct occupation, (3) whether or not such work is usually done under supervision, (4) the skill required, (5) whether P or X supplies the instrumentalities and place of work, (6) the length of time for which X is employed, (7) the method of payment (by time or by the job), (8) whether or not the work is part of P's regular business, and (9) the belief of the parties as to the relationship.

Scope of Employment. P is liable for A's torts committed while A was acting "within the scope of his employment"; that is, A must have been attending to the business of his employer (P) at an authorized time and place — in other words, his conduct must have been of the same general nature as that he is employed to perform (or incidental thereto), within authorized limits of time and space, and appreciably actuated (at least in part) by a purpose to serve P. P cannot avoid liability by proof that he forbade A to do the negligent act complained of. (A, in charge of P's lumber yard, had unloaded and piled up lumber on the sidewalk in front of T's house. P had given A express instructions not to pile lumber on the sidewalk, but to take it at once into the yard. T, while walking on the sidewalk, was injured by falling lumber. P is liable.) Nor is it a defense to P that A misunderstood his instructions and consequently was not doing the work he was ordered to do: it is sufficient (to make P liable) that, within the foregoing limits, A was endeavoring to attend to P's business.

After a deviation from the scope of his employment, A does not re-enter it until (with intent to serve P) he is again reasonably near the authorized limits of time and space.

Use of Instrumentalities. P is not liable for harm caused to T by S's negligent operation of an instrumentality unless at the time of the injury S was acting within the scope of his employment. (Some statutes, like the New York Motor Vehicle Law, provide that the owner of a motor vehicle shall be liable to third persons for damage caused by its negligent operation where the owner has given the driver

permission to use it. Under such statutes it is immaterial whether or not, at the time of the accident, the vehicle was being used on P's business or for some purely private purpose [business or pleasure] of the driver. P's liability does not rest on any agency relation, but merely on his ownership of the vehicle and his consent given to the driver. These statutes are interesting illustrations of the principle that public policy may require the imposition of liability without fault.)

Wilful Acts: Use of Force. P is not liable for a deliberate tort (assault, slander, trespass, conversion) committed by S and entirely unrelated to S's duties. However, if S is hired to perform acts which usually involve the use of force, P is liable to T for harm done by S through use of excessive force ("excessive" in the sense of unprivileged, more than the occasion justified).

P'S LIABILITY FOR TORTS OF AGENTS WHO ARE NOT SERVANTS

P is liable for deceitful representations within A's actual or ostensible authority, and for defamatory statements (if A had authority to make true statements in regard to the subject matter). P is liable for the fraud of his agent (A) on third persons (T) if P put A into a position which enabled A (acting apparently within his authority) to commit the fraud (even if P was entirely innocent and received no benefit and A acted solely for his own purposes).

P's Liability for Torts of Ostensible Agent. Where P holds out A as his agent to third persons (T), and T, relying on that relationship, suffers harm because of A's lack of care or skill, P is liable to T. (The P department store maintained as its own, a shoe department in charge of A. In fact, A owned the shoe department, merely leasing space from P. T is injured because of A's negligence in trying a pair of shoes. P is liable to T, if T patronized the shoe department in the belief that it was part of the P store.)

While a contract between principal (or master) and third party against liability for an employee's fault may be valid,

a provision that a contract is not to be affected by extrinsic representations does not prevent rescission by the third party of a contract procured by an employee's deceit.

NOTICE TO AND KNOWLEDGE OF AGENT

Notice to A Is Notice to P. Where A is authorized to receive notice, or where the notice relates to business which A was authorized to transact, a notification given to A is ordinarily as effective as if given to P. Similar rules apply as to notice given by A.

Knowledge of A Is Knowledge of P. P's rights or liabilities may be affected by A's knowledge of facts relevant to some matter in which A acts for P. (A, having general authority to invest P's funds, makes a loan to T, taking as security a mortgage to P on T's house. A knows that T's house is encumbered by an unrecorded mortgage held by X. The lien of P's mortgage is subordinate to that of X.) But P is not affected by A's knowledge as to:

1. A's own unauthorized acts. (A buys for P property owned by T. The property is subject to an unrecorded mortgage held by X. T agrees to give A a certain sum if he will not inform P as to the mortgage. A withholds the information from P. P's title is not subject to the lien of X's mortgage.) Or

2. Matters involved in a transaction in which A (to the knowledge of P) is dealing on behalf of X, a party adverse to P. Or

3. Matters which A is privileged or under a duty (to some third person) not to disclose. Or

4. Matters involved in a transaction in which A was acting *entirely* for his own or for another's purpose (unless A's failure to act on or communicate such knowledge to P amounts to a breach of duty or breach of faith on his own part).

Is P bound by A's knowledge as to facts acquired before he became P's agent? Authorities are in conflict on this question, but the sounder view would seem to be that P is bound if the information (which A acquired in the past) is remembered by A and present to his consciousness while he acts for P. Similarly it has been held that P is bound by the knowledge of A even as to transactions (in a continuing account) entered into after A has left P's employ.

The foregoing rules apply to notice to or by servants and subagents.

STATEMENTS OF AGENTS AS EVIDENCE

A's statements as to the existence or extent of his authority are admissible in evidence only if the making of such statements is first proved by other evidence to have been within the scope of A's actual or ostensible authority, or if such statements are shown to have been ratified. A's statements as to P's business are admissions binding upon P, if A was authorized to make statements as to the subject matter. But the mere fact that A is authorized to do an act does not imply that he is authorized to make statements about it.

Chapter XXIV

AGENT AND THIRD PARTY

CONTRACTS AND CONVEYANCES

Principal Disclosed. If A, acting only for P (who is wholly disclosed), makes a contract with T, A (unless otherwise agreed) is not liable to T in the event of P's nonperformance: A guarantees neither P's capacity nor his solvency, even though P lives or does business abroad (of which T has no notice). If A contracts as copromisor with P, A is in effect a surety for P (the principal). A may not sue T on a contract made in behalf of P unless A was either a promisee (as when P is undisclosed) or a transferee, or unless it is inferable from business customs that T is to pay A (as where T purchases from A who is a factor or an auctioneer).

Principal Partially Disclosed. In the absence of other agreement, A, purporting to make a contract with T in behalf of P (a partially disclosed principal), is a party thereto, and an intention to make P as well a party thereto is inferred; if A was in fact acting solely on his own account, he is a party to the contract unless excluded by its terms (in which case he is liable for misrepresenting his authority).

Principal Undisclosed. If A contracts on behalf of P (a totally undisclosed principal), A is a party to such contract and P also may be liable thereon unless the contract was negotiable or under seal. Either P or A may enforce the contract against T, but in the event of a dispute between P and A as to who should exercise this right, P prevails.

Negotiable Instruments. Where A signs a negotiable instrument in his own name as agent but does not disclose

or write in the name of P (the principal), A is liable for the face amount of the instrument. If P's name appears on the instrument and there is ambiguity as to whether A (who signed and executed it) is also a party, extrinsic evidence of an understanding that he was not to be such party is admissible against a holder with notice but not against a holder in due course.

Extrinsic evidence is inadmissible to show an agreement that A should not be a party to an instrument to which he has affixed his seal and in which he (A) is named as covenantor.

IMPLIED WARRANTY OF AUTHORITY

If A purports to make a contract, conveyance, or representation to T on behalf of P, whom he has no power to bind thereby, A is (in the absence of a contrary manifestation) liable to T (either for breach of an implied warranty of authority or for misrepresenting his authority), provided T did not know that A was unauthorized. While this rule does not apply merely because P may avoid liability by reason of partial incapacity (as where P is an infant), it is no defense to A that his mistake as to his authority was reasonable (as where, without A's knowledge, P is dead or has become insane or an alien enemy) or that P consented (but not in the form required: as where P orally authorizes A to sell real estate).

A may avoid such liability by clearly stating that he makes no warranty or representation as to his authority.

Incompetence of Principal. Where A makes a contract for P (a disclosed principal under contractual disability) A is liable to T for P's failure to perform if (1) A knows that T is ignorant of P's incapacity; or (2) A represents to T that P is competent. Thus, A may be personally liable if he contracts on behalf of a nonexistent corporation. Where, however, A contracts for P (an existent corporation) A does not warrant that the contract is within the charter powers (*intra vires*), as the charter is a public record open to T's inspection. A is, unless otherwise

agreed, a party to a contract which he purports to make with T in behalf of P (whom both know to be nonexistent or incompetent).

AGENT'S TORTS

A is personally liable to T for tortious acts and it is no defense to A that he was acting on P's business or in obedience to P's instructions. A is not, however, liable to T for pecuniary damage caused by A's omission to perform his duties to P properly unless either (1) A (for the purpose of harming T) deliberately fails in his duty to P, or (2) A, having (even gratuitously) undertaken (for P) action necessary for the protection of the person or property of T, later negligently fails to act at a time when the need of action was so imperative that his withdrawal (as A should have realized) exposed T's person or property to unreasonable risk of harm that would not have occurred had A not undertaken the work. (A, a junior accountant in P's employ, assists in the preparation of a financial statement for X, one of P's clients. Because of A's negligence the statement is inaccurate and X sustains pecuniary damage. X's remedy is against P, not A. P, in turn, may seek reimbursement from A.)

A must use reasonable precautions (within his authority) as to T's land or chattels (in A's custody) and as to persons (in A's control) likely to cause physical harm to the person or property of others.

The foregoing rules as to the liability of agents are applicable to that of servants and subagents.

LIABILITY OF THIRD PARTY TO AGENT

Suits by the agent in his own name in behalf of the principal may not be maintained on a contract made in behalf of a principal (P) unless the agent (A) was either a promisee therein or transferee thereof, or unless (as in the case of purchases from factors and auctioneers) it is inferable from business customs that T (third party) is to pay A. He can so sue on a negotiable instrument only if it is in his possession and payable or endorsed to him or to bearer so that he

is within its tenor, and upon a sealed instrument only if he is a covenantee therein. If he is joint promisee with P (principal) the latter must be joined as plaintiff. A may (in his own name) hold T liable for tortious interference with the possession or right to possession of chattels held by A in behalf of P (principal), recovering the same damages (and subject to the same defenses) as P, irrespective of A's liability to P.

In such actions T has the same defenses as if P (principal) were plaintiff except as to procedural defenses based on P's personal incapacity or the defense that the form or terms of a contract excluded P as a party thereto. He may avoid liability upon an unratified contract made by A (without authority) in behalf of a disclosed or partially disclosed principal (P). He may set off claims which he could set off against P (but not claims which he has against A unless P was totally undisclosed).

Chapter XXV

TERMINATION OF AGENCY

TERMINATION OF ACTUAL AUTHORITY

By Acts of the Parties.

1. By the Agreement. Actual authority comes to an end at the expiration of the time specified (if any); otherwise at the end of a reasonable time. Where A is a special agent appointed to accomplish a specified result, A's authority ends when he has achieved such result. If A has notice of the happening of an event or change in conditions (not anticipated and provided for) from which he should infer that P does not (or if he knew the facts, would not) consent to the further exercise of authority, then A's authority ends.

Examples: Where there is an unexpected change in the value of the subject matter or in business conditions, loss or destruction of the subject matter or cessation of the principal's interest therein, principal's (or agent's) loss of (or failure to acquire) a qualification without which the authorized act cannot be done legally, the outbreak of war, a change in law, a serious breach of loyalty by the agent to the principal, bankruptcy or insolvency of the agent (as to transactions wherein the state of his credit would so affect the principal's interests that his assent to further exercise of the authority should not be inferred), or bankruptcy of principal (or the substantial impairment of his assets) known to the agent.

The agent's authority revives upon the restoration of the original conditions within a reasonable time if the agent has no notice that the principal's position has been changed.

2. By Mutual Consent. P and A may terminate the agency at any time.

3. By Manifested Dissent:

(a) *Revocation.* Unless the agency in the form of a power is given as security (or, as it has been phrased, is "coupled with an interest" in the subject matter of the agency), it is revocable at any time. (P employs A for two years. At the end of six months P, without any justification whatsoever, discharges A. The agency is ended, but P is liable to A in damages occasioned by the wrongful discharge.)

(b) *Renunciation.* A may renounce or abandon his agency at any time. As in the case of P's revocation, A's renunciation (though effective to terminate the agency) may, if wrongful, subject A to liability in damages for breach of contract.

By Operation of Law.

1. By Death or Incapacity of P or A. Death or incapacity of P or A terminates the agency (unless it is in the form of an agency power). It is immaterial that A had no means of knowing that P had died — or that P had given A the particular authority in contemplation of death and had agreed with A that death was not to end A's authority. Loss of legal capacity by P or A (as by a judicial decree of insanity) terminates or suspends A's actual authority (without notice to A and despite an agreement that authority should continue in such contingency).

2. By Destruction of Subject Matter, Etc. The agency is terminated by the destruction of a particular subject matter with which, or the death or supervening incapacity of third persons with whom, A was to deal.

3. By Change of Law, Etc. The agency is terminated by change of law or by other conditions preventing or making impossible the accomplishment of the desired result.

Agency as Security Is Irrevocable. P, being indebted to A, may confer authority on A as security for the debt. (P owes A $1,000. In consideration of a binding agreement for extension of time P gives A power of attorney to collect rents due from tenants, and authorizes A to apply

on the account $1,000 from rents so collected. According to the Restatement [unless otherwise agreed] such power so given as security for the benefit of one other than P is not terminated by revocation or surrender [except by the beneficiary thereof] or by the incapacity or death of P or A [unless the duty for which it is security comes to an end at P's death.])

Agency Coupled with an Interest Is Irrevocable. Where P is indebted to A and A has a legal or equitable interest in, or possession of, the subject matter of the agency, P cannot revoke the agency during his lifetime nor does it terminate on P's death. (Such agency "coupled with an interest" would have been created if, in the preceding illustration, P had even without consideration transferred title to the rents by a valid assignment as security for P's debt to A. A would then have had a legal interest in the subject matter of the agency.) As stated, if A has mere possession of the subject matter held for the benefit of one other than P (as distinguished from a legal or equitable interest therein) his agency may, nevertheless, be "coupled with an interest." (P owes A $500. He delivers goods to A, authorizing A to sell them for P's account and to deduct from the proceeds $500. A's agency is "coupled with an interest.") And if A (although having neither title to nor possession of specific property constituting the subject matter of the agency) has properly incurred a personal liability to T at P's request and on P's behalf, P's death will not deprive A of the right to act for his own protection. (P orders A, a broker, to sell certain stocks short. A executes the order. P dies. A can keep the transaction in *statu quo* by borrowing stocks from time to time until a representative of P's estate is appointed.)

The mere fact that A is interested in the exercise of a power (held for the benefit of P) only because it entitles him to compensation therefor does not mean that the power is given as security or is "coupled with an interest." (If A is to sell specific goods for P on salary or commission, and with power to retain such commission out of the avails, the

power thus given to A is not given as security nor is it "coupled with an interest.")

TERMINATION OF APPARENT AUTHORITY

A's apparent authority as to T comes to an end when T has notice (or should know) of the termination of A's actual authority or of P's manifestation that he no longer consents to the exercise thereof or where T knows of such change of conditions that T believes P would not consent.

However, where A's actual authority is terminated by the happening of an event which destroys P's capacity to give the power or otherwise makes the authorized transaction impossible, T, who (in ignorance thereof) continues to deal with A, is not, by the great weight of authority, protected. (A was authorized to collect bills for P. After P's death, A collects from T a sum owed to P. A misappropriates the money. P's administrator or executor can compel T to pay again, notwithstanding the fact that T paid A in good faith and without notice of P's death.) Similarly T is not protected where he deals with A after P or A has been judicially declared insane, or after P or A has been adjudicated bankrupt (provided such bankruptcy renders impossible of accomplishment the object of the agency). The rule may be unjust, but in actual practice T is no doubt made aware of the facts in many cases by trade-paper notice or newspaper items.

When Apparent Authority Continues. On the principle of estoppel, where

1. A is a general agent (authorized to conduct a series of tranactions involving continuity of service), or

2. A is specially accredited agent, or

3. A has (with P's knowledge) properly begun to deal with T,

T, not having notice of the termination of A's authority, is protected if he continues to deal with A, although A's actual authority has been terminated by some cause other than incapacity or impossibility. Similarly, T can enforce P's

liability on the ground of estoppel where P has entrusted to A a power of attorney or other written evidence of authority intended to be shown to third persons, and A, after his actual authority has been revoked by P, exhibits the writing to T, who deals with A in reliance thereon and without notice of A's lack of authority.

NOTICE OF TERMINATION OF ACTUAL AND APPARENT AUTHORITY

A's apparent authority as to T is terminated by notification given by P to T. If T (having dealt with A as agent on former occasions) learns indirectly that A's actual authority has been terminated, he cannot safely continue to deal with A as an agent. In such circumstances T is not protected by the fact that he received no notification from P of the termination of A's authority. The reason is clear: A's authority is not actual. Apparent authority rests on estoppel. We must find the element of justifiable reliance on continued authority. T's reliance on A's continued authority is not justifiable if he has learned (from whatever source) of its termination. Such information is sufficient to put T on inquiry.

When Personal Notice Is Required. A notification by P to T is effective to terminate A's apparent authority when:

1. P states the fact to T, or

2. P has delivered to T in person or at his home or place of business or other proper place a writing stating such fact. Such personal notice must be given to T if:

(a) T has extended credit to, or received credit from, P through A in reliance on P's representation of A's continuing authority,

(b) A has been specially accredited to T, or

(c) T has begun to deal with A (as P has reason to know) or

(d) T (as P should know) relies on possession by A of indicia of authority entrusted to A by P.

Public Notice. Where personal notice is not thus required, notice of termination by P is sufficient if advertised in a newspaper of general circulation where the agency is regularly carried on or given other reasonable publicity. The same general rules apply to terminating the actual or apparent authority of a subagent.

Part V: Negotiable Instruments

Chapter XXVI

COMMERCIAL IMPORTANCE OF NEGOTIABILITY

HOLDER IN DUE COURSE

An assignee stands in the shoes of his assignor. (A sells and delivers goods to D. D notifies A that the goods are not what he ordered and refuses to pay for them. The goods, in fact, are not as ordered. If A sues D for the price, D can successfully defend [breach of contract by A]. If A assigns the account to P and P sues, D can interpose the same defense against P. Moreover, the defense, if proved, would be good notwithstanding the fact that when P bought D's account he did not know of any dispute between A and D.)

On the other hand, one who buys or discounts a negotiable instrument may have greater protection and be in a more advantageous position than a mere assignee. Assume that, in the preceding example, D had given A his promissory note for the price of the goods and that D had refused to pay the note, claiming that the goods were not in conformity with the contract. If A sues D on the note, D's defense is good. But D's defense will be cut off if A negotiates the note to P (complete and regular on its face) for value and before maturity, P acquiring it in good faith and without notice of any infirmity therein or defect in A's title. Then, if P sues D, D's defense will be of no avail. P, in this illustration, is said to have acquired the note as a *holder in due course.* Roughly, the expression means one who takes commercial paper (negotiable instruments) in the ordinary course of business. The holder in due course is in a more favorable position than the mere assignee of a nonnegotiable money claim because:

1. He takes the instrument free of most defenses available to prior parties among themselves, and

2. He may retain and enforce the instrument even though it had been lost or stolen from its original owner (in this respect bearer paper is like currency: one who takes it from a thief or finder may be protected).

To summarize: the rule that one can pass no better title to personal property than he himself has does not apply to commercial paper, and negotiation to a holder in due course cuts off certain defenses, thereby differing from assignment which subjects the assignee to all defenses available to the debtor against the assignor. From the standpoint of one who buys, discounts, or lends money on the security of negotiable instruments, this special protection and advantage is of primary importance. If, at the outset, one clearly understands the favored position of the holder in due course, the essential purpose which informs the law of Bills and Notes becomes manifest: to define with great exactitude a form or forms of written instruments which shall be well adapted for use in credit or security transactions and investments, such as:

1. **Loans.** The borrower usually gives his promissory note secured by mortgage or by the deposit of stock, bonds, or other collateral.

2. **Sales on Credit.** Notes and acceptances are obligations to pay for services or goods sold on credit; hence they are called credit instruments.

3. **Investments.** Banks and finance companies purchase notes and acceptances. Thus, trade-acceptances are favored by banks as credit instruments because of their self-liquidating character. The Federal Reserve Act makes eligible for rediscount by reserve banks, notes, drafts, and bills held by a member bank, having a maturity at the time of rediscount of not more than 90 days, "arising out of actual commercial transactions; that is . . . issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been or are to be used for such purposes."

IMPORTANCE OF FORM

Whether or not an instrument is negotiable depends entirely on its form. The formal requirements are defined with great precision; hence it is possible (in most cases) to tell at a glance whether or not an instrument is nego-

tiable, and accordingly to gauge the risks involved in discounting or taking it as security.

HISTORY

In England the law of Bills and Notes developed as a branch of the law merchant, which was administered by the special mercantile courts and those of the great fairs. Later the king's courts began to take mercantile cases and applied the law merchant in commercial cases admitting evidence of mercantile usage if the party pleading such usage first proved himself to be a merchant. Thus was made possible that fusion of the two legal systems (the law merchant and the common law) brought about almost singlehanded by Lord Mansfield over a period of no more than thirty years. In England the law of negotiable instruments was codified by the Bills of Exchange Act (1882). In the United States there was much confusion and lack of uniformity in the decisions, and in 1895 the National Conference of Commissioners on Uniform State Laws was appointed to revise and codify the law merchant. The Conference drafted the Uniform Negotiable Instruments Law (completed in 1896), which has since been adopted (with modifications) by every state.

CHAPTER XXVII

KINDS OF NEGOTIABLE INSTRUMENTS

All kinds of negotiable instruments are either promises or orders to pay money.

PROMISSORY NOTES

Promises to Pay Money.

Form No. 1. (Time Note).

$ 500.00 New York, N. Y., September 15, 1942

Ninety days - - - - - - - - - - - AFTER DATE THE UNDERSIGNED PROMISE(S) TO

PAY TO THE ORDER OF Frank Smith

Five Hundred and - - - - - - - - - - - - - - - no/100 DOLLARS

AT THE NATIONAL BANK OF NEW YORK, N.Y.

VALUE RECEIVED, with interest

NO. 1015 DUE Dec 14, 1942 John C. Jones

Form No. 2. (Demand Note).

$ 300.00 NEW YORK, N.Y. November 1, 1942

On demand - - - - - - - - - - - - - - AFTER DATE I PROMISE TO

PAY TO THE ORDER OF Jane Doe

Three hundred and - - - - - - - - - - - - - - - - no/100 DOLLARS

AT The First National Bank, New York, N. Y.

VALUE RECEIVED with interest at 6% per annum

No 3401 DUE on demand Henry Adams

Form (1) or (2) can be made into a judgment note by adding the following:

and hereby authorize any attorney at law to appear in any court of record in the United States, after the above obligation becomes due and waive the issuing and service of process and confess a judgment against me in favor of the holder hereof, for the amount then appearing due, together with costs of suit, and thereupon to release all errors and waive all right of appeal.

JOHN C. JONES (Seal).

This clause enables the holder to obtain judgment without the delay usually incident to a law suit, as it eliminates the necessity for trial. Judgment notes are, however, in use in but a few states. Although a provision for the entry of judgment after maturity does not affect negotiability, most states have by statute established a certain procedure which must be followed in order to obtain a judgment by confession, so that little is to be gained (in such states) by the use of the judgment note form. (Collateral, retention title, and mortgage notes are discussed under Formal Requirements, Ch. XXVIII.)

Form No. 3 (Certificate of Deposit).

CERTIFICATE OF DEPOSIT

THE FIRST NATIONAL BANK

NO. 50 NEW YORK, N.Y. August 4, 1942

Frank Brown DEPOSITED IN THIS BANK

Five Hundred and 50/100 - - - - - - - - - - - - - - - - - - DOLLARS

PAYABLE TO THE ORDER OF. Himself

ON RETURN OF THIS CERTIFICATE PROPERLY ENDORSED

$ 500 50/100 John Jones, CASHIER

Certificates of deposit are issued to be used as money (especially for the transmission of funds to make pay-

ments), the bank having the use of the money, the holder getting no interest. Do not confuse this certificate of deposit with the deposit slip issued by the bank when checks or cash are deposited in a checking account. A deposit slip is a mere receipt. The certificate shown above satisfies the requirements for a negotiable instrument. However, not every certificate of deposit is negotiable in form.

BONDS

Bonds are written promises under seal to pay money. (a) *Debenture bonds* are, in general, the weakest form of corporate bonds, as they are unsecured. (b) *Mortgage bonds* are secured by a lien on real property (bridge, dock, divisional, and terminal bonds). (c) *Collateral trust bonds* are secured by the pledge of securities (other than those of the obligor). The obligor delivers such securities to a trustee who holds them for the benefit of the bondholders. (d) *Equipment obligations* or *equipment trust certificates* are secured by a lien on railroad equipment (rolling stock). The bonds described in (b), (c), and (d) generally refer to the security contract and embody some of its terms. Whether such reference and inclusion affect the negotiability of the bonds will be considered in the following chapter. (e) *Bearer bonds* are made payable to bearer, and are negotiable. (f) *Registered bonds.* The owner of a bearer bond takes the risk of loss or theft. Such risk may be eliminated by having the bond registered. The name of the owner then appears on the face of the bond, and he is registered as owner in the books of the corporation. A registered bond is nonnegotiable and transferable only by entries on the corporate records showing the name of the transferee. (g) *Coupon bonds* are promissory notes (usually payable to bearer) attached to bonds. Coupon bonds are in amounts equal to the interest due at stated intervals on the principal sum named in the bond. Registered coupon bonds are registered as to principal only, the interest coupons being negotiable.

BILLS OF EXCHANGE (DRAFTS)

Orders to Pay Money.

Form No. 4 (Bill of Exchange).

NEW YORK, N. Y., August 24, 1942

At thirty days sight PAY TO THE ORDER OF

John Smith $ 500.00

Five Hundred and - no/100 DOLLARS

FOR VALUE RECEIVED AND CHARGE TO ACCOUNT OF

To George Jones
Chicago, Ill.

Frank Brown

Note that there are three parties named on this paper: (1) the drawer, Frank Brown, (2) the drawee, George Jones, (3) the payee, John Smith. Drafts are sometimes called three-name paper. *A check* is a demand bill of exchange drawn on a bank. If drawn by one bank on another bank, a check is called a *bank draft.* Ordinarily a bank draft is a more acceptable medium of payment than the check of a private individual, because of the bank's superior credit and resources. A check drawn by a bank on itself and signed by its cashier is a *cashier's check.*

Form No. 5 (Trade Acceptance).

TRADE ACCEPTANCE

No. 50 $ 500.00

August 31, 1942

Sixty- - - - - - - - - - - - - - - - - DAYS AFTER DATE PAY TO THE ORDER OF

Ourselves

Five hundred and - - - - - - - - - - - - - no/100 DOLLARS

THE TRANSACTION WHICH GIVES RISE TO THIS INSTRUMENT IS THE PURCHASE OF GOODS BY THE ACCEPTOR FROM THE DRAWER. THE DRAWEE MAY ACCEPT THIS BILL PAYABLE AT ANY BANK, BANKER OR TRUST COMPANY IN THE UNITED STATES WHICH SUCH DRAWEE MAY DESIGNATE.

ACCEPTED
DATE September 3, 1942
PAYABLE AT National Bank (BANK)
LOCATION OF BANK New York City
SIGNATURE John Lord

TO John Lord
465 Broadway, N.Y.City

DUE Oct. 30, 1942

SF 1671 PS / S C REV JUNE 1940

Artex Co., Inc.,
By Richard Roe, Pres.

This trade acceptance is a special form of bill of exchange. It is drawn by the seller on the buyer for the price of goods sold. Note that it is payable to the seller's order. When accepted by the buyer, it is an acknowledgment of the buyer's obligation arising out of the "purchase of goods by the acceptor from the drawer." Trade acceptances are favored by banks as credit instruments because of their self-liquidating character.

A draft for the price of goods drawn on and accepted by a bank (in accordance with a previous arrangement between the bank and the buyer) is called a *banker's acceptance.* A banker's acceptance would in general be more desirable as a credit instrument than a trade acceptance for the same reasons that a bank draft has stronger credit than the check of a private individual. When the bank accepts, it customarily requires the buyer either to create in the bank some security interest in the goods purchased or to keep on deposit an amount sufficient to meet the acceptance at its maturity date. Thus, the bank lends its credit to the buyer, and the seller obtains a negotiable instrument which he should be able to discount on comparatively favorable terms. The regulations of the Board of Governors of the Federal Reserve System (Sec. 6, Regulation A) prescribe the conditions under which such paper is eligible for discount by a Federal Reserve Bank for any of its member banks.

QUASI-NEGOTIABLE INSTRUMENTS

Technically, a negotiable instrument comprises an unconditional order or promise to pay money and creates an obligation *in personam.* This technical definition excludes many credit instruments and documents creating rights *in rem* which enjoy, in various degrees, some of the attributes of negotiability (security receipts, equipment trust certificates, corporate bonds embodying provisions of trust deeds, municipal warrants, trading stamps, stock certificates, warehouse receipts, and bills of lading). It must be emphasized,

however, that if an instrument calls for an act other than the payment of money, it is not (within the meaning of the Uniform Negotiable Instruments Law) a negotiable instrument, and, accordingly, the provisions of the Uniform Law are not applicable to it.

Chapter XXVIII

FORMAL REQUIREMENTS OF NEGOTIABILITY

The Uniform Negotiable Instruments Law provides that: "An instrument to be negotiable must conform to the following requirements:

1. It must be in writing and signed by the maker or drawer;

2. Must contain an unconditional promise or order to pay a sum certain in money;

3. Must be payable on demand, or at a fixed or determinable future time;

4. Must be payable to order or to bearer; and

5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with a reasonable certainty."

We shall discuss each of these requirements in some detail.

"IN WRITING AND SIGNED"

The signature of the maker or drawer may be any mark (X or a rubber stamp or printed signature effectively adopted) manifesting an intent to execute the instrument and to obligate the signer for its payment. It may be in the body of the instrument rather than at the end.

"UNCONDITIONAL PROMISE OR ORDER TO PAY A SUM CERTAIN IN MONEY"

A promissory note should contain the word "promise" or equivalent promissory terms (including "payable" or "to be paid") on the face of the instrument. A bare acknowledgment of indebtedness (an I.O.U. or "due John Smith

$50.00") is not a negotiable instrument. But if words of negotiability are added ("due A or bearer" or "due A or order") most courts hold the instrument negotiable, although it contains no express promissory words. A draft or bill of exchange must contain an order — that is, an unconditional direction by one party to another to pay — as distinguished from a mere request or even a written authorization to a debtor to pay some person other than the creditor ("Please to let the bearer have seven pounds and place to my account, and you will oblige," *held* not a bill of exchange; but the inclusion of the usual terms of civility does not necessarily imply that a favor is asked).

Unconditional Promise or Order. An instrument payable upon a contingency is not negotiable and the happening of the event does not cure the defect (a promise to pay to the order of A on his 21st birthday). Reference (in an instrument) to an extrinsic paper does not impair negotiability unless it qualifies the order or promise to pay, making it conditional, in the sense of requiring examination of the extrinsic paper in order to determine rights and obligations under the instrument (a note which recites that it is given "in accordance with" a certain contract may be negotiable, but if the words "subject to the terms of" were substituted for "in accordance with" negotiability would be destroyed).

1. **Reference in Bond to Trust Mortgage.** The negotiability of a bond or note is not necessarily destroyed by a mere reference to a mortgage or security contract (bonds "all equally secured by and entitled to the benefits and *subject to all the provisions*" of a trust mortgage . . . "to which reference is hereby made for a description of the property mortgaged and pledged, the nature and extent of the security, the rights of the holders of the bonds with respect thereto, the manner in which notice may be given to such holders, and the terms and conditions upon which said bonds are issued and secured," *held* negotiable notwithstanding the italicized phrase). But if the reference in the bond or note *subjects it to some condition or contingency* described in the mortgage, the bond or note is not negotiable. The principle is clear but its application has given rise to much uncertainty.

2. **Retention Title Notes.** Where goods are sold under a contract of conditional sale, the promissory note given by the buyer for the price may contain a (title retention) clause, providing that title to the goods sold is reserved in the payee or a subsequent holder of the note until it is paid, and conferring upon the payee

or holder the right to repossess the goods upon the maker's default. Since the (security) title reserved by the seller passes automatically to the buyer on payment of the final instalment, most courts hold that the provision for retention of title does not make the promise to pay conditional. But a provision that the buyer is to obtain neither title nor indefeasible possession until he makes the final payment has been held to destroy negotiability, making the promise to pay conditional on the transfer of possession.

3. **Trade Acceptances.** A statement of the transaction which gives rise to the instrument does not affect its negotiability. "The transaction which gives rise to this instrument is the purchase of goods by the acceptor from the the drawer," Form No. 5, p. 171. Slight variations from or additions to this form may destroy negotiability ("per invoice of" or "as per contract"). Decisions are in conflict as to the effect of clauses granting a discount if the acceptance is paid before maturity. Courts have differed as to whether negotiability of the trade acceptance is destroyed by the clause: "maturity being in conformity with the original terms of purchase." Such deviations from, or additions to, standardized negotiable forms should be carefully avoided.

An instrument, otherwise negotiable, is not made nonnegotiable by the inclusion of a direction to debit a particular account or the indication of a particular fund out of which reimbursement is to be made; but an order or promise to pay *out of* a particular fund only is not unconditional (promise to pay a certain amount "out of my profits on 3 East 40th Street job"). To be negotiable, the instrument must carry the *general personal credit* of maker or drawer.

To Pay a Sum Certain. The promise or order must call for the payment of a sum certain. (The sum is not rendered uncertain by a clause in a note whereby the maker empowered the payee to "appropriate on the note, whether or not due, at any time, at its option, without notice or legal proceedings" any money the maker might have in the payee bank on deposit or otherwise [presumably indorsing such appropriation on the note]. But the instrument would be nonnegotiable if the amount payable depended on what might be realized from collateral and was therefore uncertain, or if the note recited that the maker had a right to have the transaction re-examined in order to ascertain the amount rightly due and payable thereunder.)

1. **Interest.** Where the instrument provides for the payment of interest without specifying the date from which interest is to run, the interest runs from the date of the instrument (if the

instrument is undated, from the issue thereof). Most courts hold that negotiability is not impaired by a provision that the instrument is to bear interest after maturity (or from its date) if not paid when due, or at a higher rate if not paid, or at a lower rate if paid, or is to bear interest on interest.

2. **Instalment Note.** The sum may be certain although payable by stated instalments; or by stated instalments, with a provision that, upon default in payment of any instalment or of interest, the whole shall become due (*acceleration clause*). An acceleration clause does not make an instrument payable upon a contingency (and so nonnegotiable) since the time of payment must surely come.

3. **Exchange.** Merchants having occasion to use their funds at their place of business sometimes make the currency at that point the standard of payments made to them by their customers at a different point. Thus a bill of exchange payable in Seattle with exchange on New York requires precisely the same sum of money to pay it as would be required had it been payable in New York. The exchange is the cost of drawing a bill and transmitting the money to New York (the expense of providing funds in New York) to meet it. Accordingly, a provision for payment of a sum certain plus exchange, whether at a fixed rate or at a current rate, does not impair negotiability.

4. **Costs of Collection or Attorney's Fee.** Negotiability is not impaired by a provision that in case payment shall not be made at maturity, there shall be added to the amount due on the note costs of collection or an attorney's fee. Recovery for attorney's fees is limited to a reasonable amount not exceeding the stipulated sum.

In Money. The promise or order must call for the payment of money, but it may designate "a particular kind of current money in which payment is to be made." "Money," "current money," and "current funds" are ambiguous phrases. There are three possible meanings:

1. Legal tender, or

2. Media lawfully and actually circulating *at par* with legal tender at the time and place of payment (banknotes), or

3. Media lawfully and actually circulating *at or below* par as compared with legal tender at the time and place of payment.

The weight of authority excludes the third meaning and accordingly holds that an instrument payable in "current money" or "current funds" is negotiable. It is not clear whether "money" includes money which is foreign at the place of payment, but there is authority to the effect that

an instrument payable in foreign money (of a recognized nation engaged in international trade) may be negotiable since its value is determinable by the rate of exchange, and is, therefore, certain as to amount.

Acts in Addition to Payment of Money. An instrument which contains an order or promise to do any act in addition to the payment of money is not negotiable (promise to pay a certain sum of money and a specified quantity of wheat). A recital (subsidiary or auxiliary to payment) that the obligor will deliver on demand additional security to the satisfaction of a holder deeming himself insecure because of his opinion that collateral has depreciated, does not impair negotiability. Such provision merely aids the holder to secure payment, protects him from risks of insolvency, steadies the value of the instrument, and makes it circulate more readily. But a provision *accelerating* the due date if the holder deems himself insecure would make the instrument nonnegotiable, since the time of payment depends absolutely on the will and election of the holder (that is to say, on the future volition of someone other than the obligor).

Additional Provisions Not Affecting Negotiability. The negotiable character of an instrument otherwise negotiable is not affected by a provision which:

1. Authorizes the sale of collateral securities in case the instrument is not paid at maturity. Or

2. Authorizes a confession of judgment if the instrument is not paid at maturity. (The instrument is negotiable if the power to confess judgment means "any time after maturity," but not if it means "at any time after issue" [and so, possibly, before maturity]). Or

3. Waives the benefit of any law intended for the advantage or protection of the obligor. However, such waiver is ineffective on the ground of public policy as applied (a) to the discharge in bankruptcy of the maker of a note reciting a waiver "of all benefits that any laws give for the advantage or protection of the debtor," and (b) to the benefit of homestead or exemption laws (in most states). Or

4. Gives the *holder* an election to require something to be done in lieu of payment of money. Convertible bonds and notes may thus be negotiable, since the option is that of the holder and not of the obligor. (If the obligor has the right to discharge his duty by the payment of something other than money, the instrument

is not negotiable, as where D acknowledged receipt of bonds and and promised to deliver those [or like] bonds, or a sum of money equal to their value, to the order of A.)

The validity and negotiable character of an instrument are not affected by the fact that it is not dated, or does not specify the value given or that any value has been given therefor, or does not specify the place where it is drawn or the place where it is payable, or bears a seal.

"MUST BE PAYABLE ON DEMAND, OR AT A FIXED OR DETERMINABLE FUTURE TIME"

Demand Paper. An instrument is payable on demand:

1. Where it is expressed to be payable on demand, at sight, or on presentation (the words "on demand" are usually in promissory notes: the words "at sight," in a bill of exchange, hence the term "sight draft");

2. In which no time for payment is expressed (a check);

3. With respect to a person who issues, accepts, or indorses it when it is overdue. (D on May 15, 1940, indorses a promissory note made January 15, 1940, and falling due on April 15, 1940. As to D the note is a demand instrument. In order to hold D liable as indorser the note must, within a reasonable time after D's indorsement, be presented to the maker for payment; and if payment is refused, D must be given due notice of dishonor.)

Time Paper. An instrument payable on some specified future date is payable at a fixed time (a promissory note dated March 1, 1938, payable June 1, 1938). The following instruments are payable at a "determinable future time" within the meaning of the Act:

1. Those payable at a fixed period after date or sight (a promissory note payable 60 days after date, a bill of exchange payable at 60 days' sight);

2. Those payable on or before a fixed or determinable future time specified therein (a promissory note payable on or before 60 days after date);

3. Those payable on (or at a fixed period after) the

occurrence of a specified event which is certain to happen, though the time of happening be uncertain. A promissory note payable on, or at a fixed period after the death of a third party is generally held negotiable, on the ground that death is not a contingency but an event certain to happen. But by the same reasoning a note payable "on my 25th birthday" is not negotiable: it is not certain that the maker will attain the age of 25. It is not essential that the happening of the event precipitating the maturity depend upon the future volition, or be wholly under the control, of the obligor; it may be beyond his control, as well as that of the holder. It has been held, however, that negotiability is destroyed where acceleration is entirely under the control, or dependent on the whim or caprice, of the holder so that the time of payment is absolutely uncertain.

4. Those payable by stated instalments, with a provision that upon default in payment of any instalment or of interest, the whole shall become due. An acceleration clause of this type does not affect negotiability. Of uncertain effect on negotiability are the following:

(a) Provisions for automatic acceleration on breach of some collateral agreement made by the maker (to pay taxes on and insure specified property; not to remove property from a specified location; not to encumber specified property; to furnish additional collateral at the request of the holder). Many courts uphold the negotiability of such paper on the realistic ground that the accelerating provisions make it more salable and enhance its value as a base for the extension of credit. Other courts object that such paper is not only uncertain as to time of payment but requires the performance of acts other than the payment of money.

(b) Provisions for automatic acceleration on the maker's insolvency, or on attachment of property securing the note. Some few states have upheld the negotiability of such paper.

(c) A provision giving the holder an option to declare the entire amount due and payable whenever he deems himself insecure. Such paper is generally held not to be negotiable on the ground that the power of maturing the instrument rests entirely in the hands of the holder, who may exercise it arbitrarily and irrespective of any act or omission of the maker. Such provision, however, would not affect the negotiability of a demand instrument, which, in any event, is due on issuance.

(d) A provision giving the maker an option to pay all or part of the principal at any time before maturity is generally held not to impair negotiability.

5. By the majority rule negotiability is not impaired by

a stipulation in a time note to the effect that makers, indorsers, and guarantors agree that the time when the holder has the absolute right to demand payment may (with the concurrence of the makers and without further notice) be extended to a new fixed date at or after the stated maturity or with operative effect therefrom. In most jurisdictions a provision for the acceleration of maturity (at the option of the holder) of a whole series of notes upon default as to any one does not impair negotiability.

"MUST BE PAYABLE TO ORDER OR TO BEARER"

The words "to the order of," "or bearer," "and bearer" are standardized words of negotiability, and their use obviates any question as to the equivalence of other expressions.

Order Paper. Order paper is defined in the Act as an instrument payable to the order of a specified person or to him or his order, as where it is payable to the order of: (1) a payee who is not maker, drawer, or drawee; or (2) the drawer or maker; or (3) the drawee; or (4) two or more payees jointly; or (5) one or some of several payees; or (6) the holder of an office for the time being. Where a note is drawn to the maker's own order it is not complete until indorsed by him. The certainty requisite for negotiability is satisfied (in most jurisdictions) by an instrument payable to the order of: "the estate of A," "the executor of the will" (or "the administrators of the estate") of A, the holder of a designated office, the "heirs of A" (a living person), A "or his assigns," or a business name assumed and adopted by the person in interest.

Bearer Paper. The instrument is payable to bearer:

1. When it is expressed to be so payable; or

2. When it is payable to a person named therein or bearer; or

3. When it is payable to the order of a fictitious or nonexisting person, and such fact was known to the person

making it so payable (this provision is discussed under Impersonation, page 227 *infra*); or

4. When the name of the payee does not purport to be the name of any person (check payable "to the order of cash," or to "bills payable or order"). Here the drawer presumably intends that the instrument shall be negotiable by mere delivery, as if he had made it payable "to bearer," indorsement by the payee being impossible.

5. When the only or last indorsement is an indorsement in blank. An instrument payable to the order of A and by A indorsed in blank and delivered to B is (in the hands of B) bearer paper. B can negotiate the instrument to C by mere delivery without indorsement. If, however, the instrument were payable to bearer on its face, it would remain bearer paper even if A indorsed: "Pay to the order of B" (special indorsement) and delivered it to B. B could negotiate the instrument (bearing A's special indorsement) to C by mere delivery without indorsement—though A would not be liable to C, as the latter could not make title through A's indorsement.

Chapter XXIX

NEGOTIATION AND ASSIGNMENT

NEGOTIATION AND ASSIGNMENT

A negotiable instrument may be *either* negotiated *or* transferred. A check payable to the order of A can be transferred (by assignment) to B without the indorsement of A, but such transfer is not a negotiation; and B, although he has physical possession of the instrument, is not a "holder" in the technical sense of the Act (holder being defined as: payee or indorsee of a bill or note, who is in possession of it, or the bearer thereof). B is a mere assignee subject to defenses, if any, which the drawer might have asserted against A. (True, B has the right to compel A to indorse, but then the negotiation takes effect as of the date on which A actually indorses, not the date on which B first acquired the instrument.) A transferee cannot be a holder unless the instrument has been *negotiated* (not merely assigned) to him, and it is obvious that one cannot be a holder in due course unless he is a holder.

Indorsement. Order paper is negotiated by the indorsement of the holder completed by delivery. Bearer paper can be negotiated by mere delivery without indorsement. An indorsement must be made on the instrument. If, however, there is no space on the instrument, the indorsement may be made on a separate piece of paper (called an *allonge*) attached to the instrument. Indorsement must be of the entire instrument or of the unpaid balance. (A attempts to indorse to B $50 out of a $100 promissory note. There has been no negotiation to B. B can enforce his rights as equitable assignee, not as a

holder.) Where an instrument is payable to the order of two or more payees or indorsees who are not partners, all must indorse, unless the one indorsing has authority to indorse for the others.

An indorsement may be *blank*:

(1) Henry Brown

(The holder may convert a blank indorsement into a special indorsement by writing in over the indorser's signature a direction to pay the holder.)

An indorsement may be *special*:

(2) Pay to Frank Jones
Henry Brown

(The omission of the words "order of" in an indorsement does not affect the negotiability of an instrument which is negotiable on its face.)

There are four kinds of indorsement: General, Qualified, Restrictive, and Conditional. Any one of these four kinds may be either blank or special.

KINDS OF INDORSEMENT

General Indorsement. Example (1) above illustrates a general blank indorsement, and (2) is a general special indorsement. The general indorser (whether blank or special) undertakes that (if the requirements of diligence are met) the instrument will be paid; the nature of his liability will be considered in detail in a later chapter. The following have been held by most courts to be general indorsements:

1. "I hereby assign all my right, title, and interest in and to the within instrument."

2. "I hereby guarantee the within instrument" (although there is disagreement as to whether one by such writing incurs the liability of an indorser or that of a guarantor, and as to whether such contract is negotiable or merely assignable).

Qualified Indorsement. A qualified indorsement is

(3) Pay to Factors Finance Corporation
without recourse

Martin Black

used where the indorser wishes merely to assign the instrument *without guaranteeing* payment. (Black in the preceding indorsement [3] may be a dealer who has received the instrument from a customer. He may wish to discount it without becoming personally liable in the event his customer fails to pay.) The qualified indorsement ("without recourse") is also appropriately used wherever a person serves as a mere conduit for the passage of funds (trustees, attorneys, executors, administrators, guardians indorsing paper [payable to them in their fiduciary capacity] to those entitled to the proceeds). A qualified indorsement does not impair negotiability nor does it operate to put a person on inquiry. One holding under a qualified indorsement ("without recourse" or "at the risk and cost of" the indorsee) may be a holder in due course.

Restrictive Indorsement. An indorsement is restrictive which (1) prohibits the further negotiation of the instrument (Pay D only), or (2) expresses that it is a mere authority to deal with the instrument as thereby directed and not a transfer of the ownership thereof (Pay D or order for collection), or (3) vests the title in the indorsee in trust for or to the use of some other person (Pay D for the account of X). A general or a qualified indorsement passes to the indorsee the legal title to the instrument and the right to retain the proceeds. A restrictive indorsement

(4) Pay to the First National Bank
for collection only

Frank Brown

(in the form most commonly used) expressly gives the indor-

see the right to receive payment and a number of courts have held that an indorsement for collection transfers legal title. The restrictive indorsement (4) makes the collecting bank Frank Brown's agent for the purpose of effecting collection, and puts all persons who may subsequently deal with the instrument on notice that it is the property of Frank Brown although no longer in his possession. The bank has the right to sue on the instrument and to receive payment. Until the instrument has been paid the bank (as agent) must obey Brown's instructions and must return it to Brown if he so orders. The bank may transfer its rights as indorsee (where this is authorized by the form of the indorsement) but only to further the purpose of the indorsement: collection.

Other types of restrictive indorsement are:

(5) Pay to John Smith only

(6) Pay to John Jones as attorney for
Frank Brown

(This indorsement vests the legal title in Jones as trustee for Brown, the beneficial owner.)

(7) Pay any bank or banker
First National Bank

Form (7) is used by a bank when forwarding an item through an intermediate bank or banks for collection. Courts are divided as to whether it is a restrictive or a general indorsement. The Uniform Bank Collection Act [1] provides that such indorsement "shall be deemed a restrictive indorsement and shall indicate the creation of an agency relation in any subsequent bank to whom the paper shall

1 Adopted in Idaho, Illinois, Indiana, Kentucky, Maryland, Michigan, Missouri, Nebraska, New Jersey, New Mexico, New York, Oregon, Pennsylvania, South Carolina, Washington, West Virginia, Wisconsin, Wyoming.

be forwarded unless coupled with words indicating the creation of a trustee relationship." The courts are not agreed as to whether or not a restrictive indorsement (which is essentially not so much a contract of indorsement as an authority to collect) destroys negotiability, the better view being that it does not (although a subsequent transferee is put on notice as to the rights of the restrictive indorser and takes subject to the appropriation originally designated).

Title to Items Deposited for Collection. The law as to the title to commercial paper deposited by a customer is in great confusion. Where it is deposited for the special and express purpose of collection (even though intended eventually for credit) it is generally held (whether or not the indorsement is restrictive) that title does not pass to the bank; the giving of credit to the depositor is not inconsistent with his still being owner of the paper. If the paper is deposited as cash (or the depositor is given *unconditional*, as distinguished from revocable, credit), title is usually held to be in the bank. Where there is neither a definite understanding as to the passing of title (as usually there is not) nor agreement that the paper is deposited only for collection, it is held in most courts that title to paper deposited (with an unrestricted indorsement) in the usual course of business with the bank, with the right to draw thereon, is in the bank. It has been held that an indorsement "for deposit to the credit of my account" operates as a warning that the purpose is not to transfer ownership of the instrument or of its proceeds, but to prevent its further circulation, giving "notice of the trust" to any taker, and not vesting legal title to the paper in the indorsee or authorizing the latter to sell or indorse it to another, or to hold the indorser on his indorsement (though the indorsee is permitted to sue on the instrument).

Conditional Indorsement. A conditional indorsement

(8) Pay to the order of Frank White
upon completion of alteration of
premises 66 East 130th St., N.Y. City
John Brown

creates a condition with reference to instrument and proceeds, binding in favor of the indorser (Brown) as regards the indorsee (White) and subsequent holders through the indorsee (White). A party required to pay, however, may disregard the condition and pay White (or

his indorsee) irrespective of the nonfulfillment of the condition.

INDORSEMENT OF BEARER PAPER

We have seen that bearer paper may be such either because of what is on its face, or because the only or last indorsement specifies no indorsee but is in blank. So long, however, as an instrument is bearer paper, it continues to be negotiable by delivery notwithstanding a special indorsement (although such special indorser is liable as indorser only to those making title through his indorsement).

DELIVERY

Delivery is transfer of possession, actual or constructive, from one person to another (*constructive delivery*: B's banker, A, without B's knowledge, indorses an instrument to B and puts it into an envelope containing other papers of B). A signature imposes no liability prior to delivery (except to a possible holder in due course). Delivery is essential to negotiation. Indorsement as defined by the Act "means an indorsement completed by delivery." Delivery is presumed from possession. Thus, where payee sues maker on a promissory note, the production of the note by the payee establishes prima facie that the maker delivered it to the payee. Except as against a holder in due course, the maker may overcome this prima facie presumption by proof that the note was lost or stolen.

CONDITIONAL DELIVERY

Conditional Delivery.

1. Condition Precedent. Parol evidence is admissible to show that (notwithstanding delivery) the instrument was to become operative as a contract only upon the happening of a future, contingent event, since this is a *condition precedent* to the attaching of any obligation under the written instrument (so that its obligation never commenced). (D delivers his promissory note to P, stating orally that the note is not to take effect until P delivers to D a deed to certain

property. P fails to deliver the deed, but sues D on the note. Evidence of the oral agreement is admissible. The testimony tends to show that the promissory note, which purports to be a contract, is in fact no contract at all.)

2. CONDITION SUBSEQUENT. Where an instrument is *unconditionally* delivered as an operative contract, parol evidence is not admissible to show a parol condition (not expressed in the writing) attached to the obligation of the contract, so that it is not absolute according to its terms. (D is sued by P on a promissory note given by D in part payment of his tuition fee. D seeks to testify that at the time he delivered the note to P, P promised orally that if D should decide not to continue with his course, and should so notify P before he had received more than five lessons, D would be released on the note; that D did decide to discontinue and notified P in accordance with the oral agreement. This testimony is not admissible; it is in direct contradiction of the written contract [as to the existence and validity of which there is no controversy] and its admission would violate the parol evidence rule.)

Antedating and Postdating. A negotiable instrument is not invalid merely because it is antedated or postdated, provided this is not done for an illegal or fraudulent purpose. The person to whom an instrument so dated is delivered acquires the title thereto as of the date of delivery.

Chapter XXX

OBLIGATIONS OF PARTIES PRIMARILY LIABLE

The person "primarily" liable on an instrument is the person who by the terms of the instrument is absolutely required to pay the same (the maker of a promissory note and the acceptor of a bill of exchange). All other parties (drawer and indorsers) are "secondarily" (conditionally) liable.

MAKER OF A PROMISSORY NOTE

The maker of a promissory note engages that he will pay it according to its tenor, and admits the existence of the payee and his then capacity to indorse. Diligence (due presentment for payment and due notice of dishonor) is not necessary for the purpose of charging the maker with liability (it is necessary, however, to fix the liability of indorsers). If the instrument is by its terms payable at a special place and if the maker is able and willing to pay it there at maturity, such ability and willingness are equivalent to a tender of payment upon his part. (D delivers to P an interest-bearing promissory note in the amount of $500 payable at the X bank. D has on deposit at maturity and at all times thereafter a sum sufficient to pay the note if presented. P's failure to present the note at maturity does not release D from liability for the principal sum of $500 and interest up to maturity [even though the X bank fails] but D is not liable for interest after maturity, and if P sues D on the note, D—not P—will be entitled to court costs.) Where a note is made payable at a bank, the bank is authorized to pay it without other direction from the maker.

ACCEPTOR OF A BILL OF EXCHANGE

The drawee of a bill of exchange is not liable thereon until he accepts (a check or other bill of exchange does not of itself operate as an assignment of any part of the drawer's account, and the bank or other drawee is not liable thereon to a holder unless and until it accepts or certifies the instrument). Acceptance must be in writing and signed by the drawee. It is usually made by writing across the face of the bill the word "Accepted" followed by the signature of the acceptor and the date, although the mere signature of the drawee has been held sufficient. By accepting, the drawee (1) signifies his assent to the drawer's order, (2) engages to pay the bill according to the tenor of his acceptance, and (3) admits: (a) the existence of the drawer, the genuineness of his signature, and his capacity and authority to draw the instrument; and (b) the existence of the payee and his then capacity to indorse. The bill of exchange itself implies a representation by the drawer that the drawee is already in receipt of funds to pay, and the acceptance (an admission of the truth of that representation) makes the drawee primarily liable, not only to indorsees but to the drawer himself if the latter takes up the bill: the drawee who has accepted cannot retract this admission as against a holder for value, since he has thereby obtained a suspension of the holder's remedies against drawer and an extension of credit. (For A's accommodation [that is, to lend his credit to A] P drew on D bank to the order of A and delivered the instrument to A. A delivered it unindorsed to B in payment of a prior indebtedness. B had it certified by D. P countermanded payment, but D was nevertheless protected in paying B since B [who took for value] was at least the equitable owner, with the right to have and enforce payment, and after certification by D [which had the same legal effect as certification would have had if A indorsed the instrument] to have payment from D at the charge of P.) Since the acceptor (like the maker of a promissory note) is primarily liable on the instrument, no diligence is necessary to charge him with liability. An action by payee or indorsee

(P) against acceptor (D) will not fail on the ground of absence or failure of consideration unless there was neither consideration for D's acceptance nor consideration for P's title.

Who May Accept. In general, no one but the drawee may accept: a stranger or volunteer is not bound by acceptance. However, if the bill has been dishonored and protested because of (a) refusal of the drawee to accept, or (b) bankruptcy or insolvency of the acceptor before maturity of the bill (in which event the holder may "cause the bill to be protested for better security against the drawer and indorsees"), any person (except a party already liable on the bill) may with the consent of the holder intervene and accept for *honor supra protest* before the bill is overdue. Such acceptance may be for the honor (to preserve the credit) of the drawer or an indorser "for part only of the sum for which the bill is drawn; and where there has been an acceptance for honor for one party, there may be a further acceptance by a different person for the honor of another party." The acceptor for honor is entitled to diligence.

Acceptance on Separate Paper. The holder of a bill presenting the same for acceptance may require the acceptance to be written on the bill and, if such request is refused, may treat the bill as dishonored. Where an acceptance is written on a paper other than the bill itself it does not bind the acceptor except in favor of a person to whom it is shown and who, on the faith thereof, receives the bill for value. (S, who has an account in a New York bank [D], stops at the P hotel in Chicago. S requests the P hotel to cash his check for $500. The P hotel wires S's bank in New York: "Will you pay S's check of even date in the amount of $500?" The bank by its telegraphic reply agrees to pay the check. This reply is a "virtual acceptance." The check has, in effect, been certified, and the bank is liable accordingly. But if P had inquired merely: "Is S's check on you in the amount of $500 good?" and the bank had responded: "Good," "Good now," "Good for the sum named," or "The check shall have attention," the bank could not have been held as acceptor — as such responses are merely informative, creating no obligation whatever upon D in favor of P as regards any specific check capable of identification and then held by P.)

Promise to Accept Bill Not Yet Drawn. An unconditional promise in writing to accept a bill not yet drawn is deemed an actual acceptance in favor of every person who upon the faith thereof receives the bill for value. Absolute authority to A as D's agent, in a writing signed by D, to draw on D from time to time as necessary for the purchase of goods on D's account to be consigned to B, is absolute authority to draw within the limit prescribed, and is equivalent to an unconditional promise to pay the draft.

Retention of Bill by Drawee as Constructive Acceptance. The drawee is allowed twenty-four hours after presentment in which to decide whether or not he will accept the bill; but the acceptance, if given, dates as of the day of presentation. Where a drawee to whom a bill is delivered for acceptance destroys it, or refuses within twenty-four hours after such delivery (or within such other

period as the holder may allow) to return it accepted or nonaccepted to the holder, he will be deemed to have accepted it. Many courts hold that something more than mere inaction or retention of the bill (something of a tortious character, implying unauthorized conversion) is required to constitute constructive acceptance: that there must be destruction or refusal to return after demand. Others hold that the purpose of the act is to relieve the holder from the pre-existing uncertainty and confusion and to expedite action by the drawee, and that mere retention after the expiration of the twenty-four hour period justifies the inference of an intention to assume liability (on the theory that when a bill is presented for acceptance there is an implied demand that the drawee return the bill accepted or unaccepted within twenty-four hours).

General or Qualified Acceptance. An acceptance is either general or qualified. A general acceptance assents without qualification to the order of the drawer. A qualified acceptance in express terms varies the effect of the bill as drawn. An acceptance is qualified which is:

1. Conditional; that is to say, which makes payment by the acceptor dependent on the fulfillment of a condition therein stated;
2. Partial; that is to say, an acceptance to pay part only of the amount for which the bill is drawn;
3. Local; that is to say, an acceptance to pay *only* at a particular place;
4. Qualified as to time;
5. The acceptance of one or more of the drawees, but not of all.

The holder may refuse to take a qualified acceptance and, if he does not obtain an unqualified acceptance, he may treat the bill as dishonored by nonacceptance. Where a qualified acceptance is taken the drawer and indorsers are discharged from liability on the bill, unless they have expressly or impliedly authorized the holder to take a qualified acceptance, or subsequently assent thereto. (When the drawer or an indorser receives notice of a qualified acceptance he must within a reasonable time express his dissent to the holder, or he will be deemed to have assented thereto.)

Certification Is Acceptance. The certification of a check by the drawee bank is equivalent to an acceptance. Where the *drawer* has a check certified before issuance, the drawer, indorsers, and the certifying bank are all liable thereon. Where, on the other hand, the holder of a check has it certified, the drawer and all indorsers who indorsed prior to certification are discharged. The premature certification of a postdated check is unenforceable, whether because it is manifestly beyond the powers of the bank or because it is outside the authority of the certifying officer.

Acceptance under Mistake. Under the Uniform Negotiable Instruments Law the acceptor (1) admits: (a) the existence of the drawer, the genuineness of his signature, and his capacity and authority to draw the instrument; and (b) the existence of the payee and his then capacity to indorse; and (2) engages to pay the bill "according to the tenor of his acceptance." There is a conflict of authority as to the effect of this section with reference to the certification of a check which has been raised or otherwise

altered (as by the deletion of the original payee and the substitution of another as payee). Some courts hold (in accordance with the majority rule prior to the Act) that certification warrants merely the genuineness of the drawer's signature and the sufficiency of his account: others hold that certification warrants as genuine everything appearing in the body of the check at the time of certification. Under this view the condition of the check when certified (not when drawn) determines the liability of the bank. An acceptance (or payment) does not admit that *indorsements* are either genuine or authorized, and money paid by the drawee upon forged or unauthorized indorsements can be recovered as paid by mistake.

Payment under Mistake

1. As to Sufficiency of Drawer's Account. Mistake by the drawee (P) as to the sufficiency of the drawer's account has been held (for various reasons) to be no ground for recovery from D who received in good faith an amount which the drawee chose to pay by reason thereof: to permit P to repudiate the payment would mean uncertainty, delay, and annoyance to D and would tend to destroy the certainty necessary to the mercantile usefulness of negotiable instruments. The tentative or provisional payment by the drawee through the clearinghouse, by the exchange of credits there, is subject to examination by each member (at its banking house) of the checks drawn upon it. If the drawee then concludes to pay, nothing more remains to be done, and the tentative or provisional payment becomes final. Some courts hold that upon expiration of the time prescribed by the rules of the clearinghouse, without repudiation and return by the drawee, the payment becomes absolute — "as much so as if money had passed." Others follow the Massachusetts rule that, even though it is not repudiated within the prescribed time, the drawee may still recover the amount of an item not properly chargeable against it (as paid under a mistake) unless, in reliance on the failure to return, the bank sending it through clearing has changed its position to its detriment or something occurs (subsequent to the negligent payment by mistake) making it unconscionable for P to recover since D has changed its position. A deposit-credit entered by P as a complete, unconditional, and executed transaction in favor of D (depositor of a check drawn by A on P) cannot be cancelled by P when it turns out that P's belief in A's credit was mistaken: it is as though P had paid in cash and D had redeposited the amount.

2. Forgery of Drawer's Signature (*Price* v. *Neal*). In the famous case of *Price* v. *Neal*, Lord Mansfield held that a drawee (P), having paid a bill of exchange on which the signature of A (drawer) was a forgery, cannot recover the amount so paid from D (holder of the bill in good faith and for value) unless D was negligent in taking the forged bill. Where the signatures of A (drawer) and B (payee-indorser) are both forgeries, the right of P (drawee) to recover on the ground of money paid by mistake turns on whether or not D (to whom P paid the bill) was negligent in taking it: D's warranties as indorser do not run to P (drawee). (Where P [drawee] paid D [a bona fide holder for value] an order bill on which the signature of A [drawer] was a forgery and which bore a forged indorsement, it was held that the money cannot be recovered as paid under a mistake of fact.

The entire instrument was forged and without validity. P failed to detect the forgery of A's signature, and the forged indorsement puts P in no worse position than he would occupy if it were genuine. He cannot be called on to pay again. No one else has a better title to the instrument or to the proceeds which D has received. P's equities are not superior.)

3. Forged Indorsement. P (maker or drawee) paying an order instrument to D (holder in due course) where the signature of an indorser (A) was forged may (unless estopped by his own negligence or barred by laches) recover the amount, not on the ground that D is a warrantor or promisor (since the indorsement of one presenting the instrument for payment is simply a receipt) but as money paid under mistake of fact as to the person having title and the right to demand payment, unless P's failure to give notice of the forged indorsement has caused D to change his position or to lose an opportunity to protect himself, so that P is barred by estoppel. The true owner may hold the drawee who has paid the bill under a mistake as to the genuineness of an indorser's signature on the theory of conversion (there is no privity of contract, since payment is not acceptance): or he may hold the purchaser either for conversion or (if he has collected the bill) for moneys had and received.

4. Forgery of Maker's or Acceptor's Signature. Where the maker or acceptor has paid an instrument under a mistake of fact as to the genuineness of his own signature, the courts are not agreed as to his right to recover from a holder in due course without negligence.

5. Amount Raised. While it has been held that P (drawee) having paid a bill of exchange previously raised may have restitution by quasi-contract (on the ground of mistake of fact) from D (a holder in due course) who received the money, the opposite result is reached in cases where the plaintiff was the maker or was both drawer and drawee. (When P issued an order on itself, it had notice of the true amount and was held "bound to know its own checks," and so could not recover on a raised draft paid to D, a bona fide holder.)

AGENCY

No person is liable on the instrument whose signature does not appear thereon. The doctrine of liability of an undisclosed principal does not apply to the law of Bills and Notes. But one who signs in a trade or assumed name will be liable to the same extent as if he had signed in his own name. The signature of any party may be made by a duly authorized agent. No particular form of appointment is necessary for this purpose: the authority of the agent may be established as in other cases of agency. A signature by "procuration" (*per proc.*) operates as notice that the agent has but a limited authority to sign, and the principal is bound only in case such signature by the agent was within

the actual limits of his authority. Where an instrument is drawn or indorsed to a person as "cashier," or other fiscal officer of a bank or corporation, it is deemed prima facie to be payable to the bank or corporation of which he is such officer, and may be negotiated either by the indorsement of the bank or corporation, or by the indorsement of the officer. Where any person is under obligation to indorse in a representative capacity he may indorse in such terms as to negative personal liability.

Signing in a "Representative Capacity." Where the instrument contains, or a person adds to his signature, words indicating that he signs for or in behalf of a principal, or in a representative capacity, he is not liable on the instrument if he was duly authorized; but the mere addition of words describing him as an agent, or as filling a representative character, without disclosing the principal, does not exempt him from personal liability. The rule seems clear but there is no uniformity of decision as to the effect of certain forms of signature. Thus,

"D, Treasurer of the A Corporation,
E, President of the A Corporation"

may or may not be held to bind the individuals D and E personally. Some states hold that it binds the A corporation. Others hold that there is a presumption that the words of office are merely a *descriptio personae,* leaving the officer personally liable. (Even if the presumption is recognized, there is division of authority as to whether it is one of law or of fact.) The better view is that "whenever the form of the paper is such as fairly to indicate to the eye of common sense that D signed as agent or in a representative capacity, he is relieved of personal liability if authorized." (Parol evidence held admissible [as between the original parties] to show that a check signed "D," with the words "X Grocery Company" printed on the left-hand margin, was signed by D as agent with authority: also, a promissory note with the name "X Corporation" in the margin signed by D and E ["president" and "treasurer"] discounted by P bank is to the "eye of common sense" the note of X corporation.) Aside

from this factitious difficulty as to when the principal is disclosed, there are three situations where A (agent) signs representing D (principal):

1. Where A disclosed his principal and was acting within his authority, D is liable on the instrument and A is not personally liable;

2. Where A disclosed his principal but was acting outside his authority, D is not liable; A is liable, but the decisions are not uniform as to whether his liability is on the instrument (for the face amount), for damages resulting from breach of an implied warranty of authority (the general rule before the N.I.L.), or in an action of tort for misrepresentation; and

3. Where A did not disclose his principal, D is not liable, but A is liable on the instrument.

Signing as Trustee or Executor. An instrument signed by a trustee or executor should entail personal liability even if the name of the estate is disclosed, since the estate is not a principal: the trustee or executor is the principal dealing with the property as legal owner and not merely as agent or representative. He acts for himself, though with fiduciary obligations to others. He may avoid personal liability by signing in effect "as trustee but not individually or otherwise."

ACCOMMODATION PARTY

An accommodation party is one who has signed the instrument as maker, drawer, acceptor, or indorser, without receiving value therefor, and for the purpose of lending his name to some other person. Such a person is liable on the instrument to a holder for value, notwithstanding that the latter at the time of taking the instrument knew him to be only an accommodation party. (D makes a promissory note—receiving no consideration therefor—to the order of A to enable A to discount the note with P. A cannot enforce this note against D, for absence or failure of consideration is a matter of defense against any person not a holder in due course, and partial failure of consideration

is a defense *pro tanto,* whether the failure is an ascertained or liquidated amount or otherwise. But if A discounts the note with P, P can enforce D's liability, notwithstanding the fact that P knew D's signature was made for A's accommodation.) Since a signature for accommodation is gratuitous, it may be revoked by erasure or by notice to those interested at any time before the instrument has been negotiated for value (the revocation may be effected by the death of D [the accommodating party] before negotiation of the instrument to P [holder for value] since A [the party accommodated] does not have a power coupled with an interest). But once the instrument has been negotiated for value, the value paid by P (upon the faith and credit of D's signature) has the same effect as if D had received it. A transferee (P) holding the instrument as security for an antecedent or pre-existing debt due P from A is a holder for value as against D who signed for A's accommodation. A statement by A (the party accommodated) to D (the accommodating party) in the presence of P (holder for value) that D's signature was merely a matter of form to avoid a certain technicality, and that A did not wish D to feel himself liable since A — not D — was borrowing the money, does not prevent D's being liable to P on a note made by D to P's order for A's accommodation.

First Negotiation after Maturity. The purpose of D's signing for the accommodation of A is to obtain (or to enable A to obtain) credit, but since it is understood between D and A that A is to pay (or to provide funds) at maturity (otherwise D may pay and proceed at once against A), the view more widely held is that D (even if he signed as maker or acceptor) is not liable where the first negotiation is after maturity.

Payment by Accommodating Party. Where P (the accommodating party) has been compelled to pay the instrument to A (holder), D (the accommodated party) is under a duty to reimburse P. While payment in due course (at or after maturity, to the holder, in good faith and without notice

that his title is defective) by or on behalf of maker, drawee, or accommodated party extinguishes the instrument, payment by a party secondarily liable does not have that effect; although the provision that one so paying is "remitted to his former rights as regards all prior parties," does not aid P, a drawer or indorser for accommodation of D (since P has no rights on the instrument to which he can be remitted), a number of courts allow P to recover from D on the theory that P is subrogated to A's rights in the instrument, whereas others arrive at the same result by asserting that P's remedy against D (whether P be maker, acceptor, drawer, or indorser) is on an implied obligation of reimbursement and not on the instrument.

Suretyship Defenses Not Available to Maker or Acceptor. Under the N.I.L. an accommodation maker is primarily liable. Accordingly, most courts hold that D (accommodation maker) is not discharged by a binding agreement to extend the time of payment made between P (holder for value) and A (the accommodated party), although D's consent to such extension has not been obtained and P has not reserved his rights against D. This result has been criticized on the ground that since, in substance, D is a surety, A principal debtor, and P creditor, D should be discharged by the extension agreement which would, under the Law of Suretyship, "discharge a simple contract for the payment of money." It is argued that the Act does not require the abrogation of suretyship defenses available to D before its adoption, particularly where P takes the instrument knowing that D (as accommodating maker or acceptor) is a surety.

Chapter XXXI

OBLIGATIONS OF PARTIES SECONDARILY LIABLE

The drawer and the general indorser guarantee payment of the instrument. Their obligation, however, is not absolute, but depends upon certain steps which must be taken in order to charge them with liability ("diligence"). Hence, drawer and indorsers are said to be secondarily or conditionally liable on the instrument. (It is to be noted that only the *general* indorser guarantees payment of the instrument. The qualified indorser who signs "without recourse" says, in effect: "If this instrument is not paid, I will not be liable thereon." The words "without recourse" expressly negative liability.) In order to charge the drawer and indorsers with liability the holder must:

1. Duly present the instrument for payment or acceptance, and

2. Take the necessary proceedings on dishonor.

DUE PRESENTMENT FOR PAYMENT

It will be remembered that presentment for payment is not necessary to charge the person primarily liable on the instrument, but it is necessary to charge drawer and indorsers. Presentment for payment, to be sufficient, must be made:

1. By the holder, or by some person authorized to receive payment on his behalf;

2. At a reasonable hour on a business day;

3. At a proper place as defined below;

4. To the *person primarily liable* on the instrument, or, if he is absent or inaccessible, to any person found at the place where the presentment is made (thus, in order to

charge the indorsers of a promissory note, due demand for payment must be made ***not on the indorsers but on the maker***, although the purpose of such demand is to charge the indorsers with liability and not the maker);

5. By exhibiting the instrument to the person from whom payment is demanded (when it is paid, the instrument must be delivered to the party paying it), unless the maker or drawee does not require exhibition but refuses to pay it on other grounds (presentment over the telephone or by mail is ineffective);

6. Seasonably.

Time Paper. Where the instrument is not payable on demand, presentment must be made on the day it falls due. Every negotiable instrument is payable at the time fixed therein without grace. When the day of maturity falls on Sunday or a holiday, the instrument is payable on the next succeeding business day; instruments falling due on Saturday are to be presented for payment on the next succeeding business day. Where the instrument is payable at a bank, presentment for payment must be made during banking hours (unless the person to make payment has no funds there to meet it at any time during the day, in which case presentment at any hour before the bank is closed on that day is sufficient). Where the instrument is payable at a fixed period after date, after sight, or after the happening of a specified event, the time of payment is determined by excluding the day from which the time is to begin to run, and by including the date of payment.

Demand Paper. Where the instrument is payable on demand, presentment must be made within a reasonable time after the issue; except that in case of a bill of exchange, presentment will be sufficient if made within a reasonable time after the last negotiation. Demand instruments may, at the option of the holder, be presented for payment before twelve o'clock noon on Saturday when the entire day is not a holiday.

Demand Paper: Checks. A check is a bill of exchange drawn on a bank and payable on demand. A check

must be presented for payment within a reasonable time after its issue, or the drawer will be discharged from liability thereon to the extent of the loss caused by the delay. (For example, the drawee bank fails, the drawer's account having been at all times sufficient to meet the check had it been presented for payment. If the bank pays a dividend of, say, 50% to its depositors, the drawer is liable to the holder for only half the face amount of the check.) But the indorser of a check, whether or not he is in fact injured by the delay in presentment, has a complete defense therein. The drawer of a check is regarded as the principal debtor and is therefore, not entirely discharged by lack of diligence in making presentment for payment (unless, of course, presentment is delayed so long that an action on the check is barred by the Statute of Limitations), but only to the extent of actual loss or injury caused by the delay. In determining what is a "reasonable time" or an "unreasonable time" regard is to be had to the nature of the instrument, the usage of trade or business, if any, with respect to such instruments, and the facts of the particular case.

In the case of a check, where the holder receives it immediately from the drawer in the city or town where it is payable, it should be presented for payment before the close of banking hours on the next business day after it is received; if he receives it in a place remote from the place of payment, it should be forwarded to some person at that place on the next business day after it is received, and presented before the close of banking hours on the day after its receipt. In some states which have not amended the N.I.L. it would seem that, regardless of how long checks are outstanding, they are in circulation so long as one negotiation properly follows another and that the indorser, therefore, is not as a matter of law prejudiced by the consequent delay in their presentment for payment provided only that presentment is made (1) within a reasonable time after the *last negotiation* and (2) before the Statute of Limitations has run. The drawer of the same check, on the other hand,

would be discharged by prejudicial delay *after its issue* to the extent of the loss thereby caused — a ridiculous result.

To Whom Presentment May Be Made. Where the person primarily liable on the instrument is dead, and no place of payment is specified, presentment for payment must be made to his personal representative, if there is any such, and if, with the exercise of reasonable diligence, he can be found. Where the persons primarily liable on the instrument are liable as partners and no place of payment is specified, presentment for payment may be made to any one of them, even though there has been a dissolution of the firm. Where there are several persons, not partners, primarily liable on the instrument and no place of payment is specified, presentment must be made to each.

Place of Presentment. Presentment for payment is made at the proper place: (1) where a place of payment is specified in the instrument and it is there presented; (2) where no place of payment is specified and no address is given and the instrument is presented at the usual place of business or residence of the person to make payment; (3) in any other case, if presented to the person to make payment wherever found, or if presented at his last known place of business or residence.

When Presentment Not Required. Presentment for payment is not required in order to charge the drawer where he has no right to expect or require that the drawee or acceptor will pay the instrument, or to charge an indorser where the instrument was made or accepted for his accommodation, and he has no reason to expect that the instrument will be paid if presented. (A, as a favor to D, makes and delivers to D a promissory note payable to the order of D. A does this to enable D to obtain a loan from the P bank. D indorses the note and discounts it at the P bank. Although A, as maker, is primarily liable on the instrument, D is, in substance, the principal debtor and A stands as surety for the debt. If A is compelled to pay, he can [on one theory or another] obtain reimbursement from D. D has no reason to expect that A will pay this

note at maturity: it is D's duty to provide funds for that purpose. Accordingly, presentment for payment is not required in this exceptional instance to charge D with liability as indorser.)

Excuses for Delay or for Non-Presentment. Delay in making presentment for payment is excused when the delay is caused by circumstances beyond the control of the holder, and when not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate, presentment must be made with reasonable diligence. Presentment for payment is dispensed with (1) where after the exercise of reasonable diligence presentment cannot be made; (2) where the drawee is a fictitious person; (3) by waiver of presentment, express or implied (the words "Protest Waived" appearing on the face of the instrument operate as an express waiver of all steps otherwise required to be taken in order to fix the liability of drawer and indorsers).

When Instrument Is Dishonored by Nonpayment. The instrument is dishonored by nonpayment when (1) it is duly presented for payment and payment is refused or cannot be obtained; or (2) presentment is excused and the instrument is overdue and unpaid. Subject to the provisions of the N.I.L., when an instrument is dishonored by nonpayment, an immediate right of recourse to all parties secondarily liable thereon accrues to the holder.

PRESENTMENT FOR ACCEPTANCE

Presentment for acceptance must be made:

1. Where a bill of exchange is payable after sight, or in any other case where presentment for acceptance is necessary in order to fix the maturity of the instrument (draft payable "at thirty days' sight" or "thirty days after sight" is due thirty days after the date on which the draft was presented to the drawee for acceptance, whether the drawee accepted or not); or

2. Where the bill expressly stipulates that it shall be presented for acceptance; or

3. Where the bill is drawn payable elsewhere than at the residence of place of business of the drawee.

In no other case is presentment for acceptance *necessary* in order to render any party to the bill liable. It is nevertheless *desirable* to present all bills for acceptance, whether required by law or not. By doing so the holder obtains acceptance (by which the credit of the paper is presumably strengthened) — or else, if the bill is dishonored by the drawee's refusal to accept, the holder, on taking the prescribed steps, has an immediate right of recourse against the drawers and indorsers and is not obliged to re-present the bill for payment at maturity. Where a bill is duly presented for acceptance and is not accepted within the prescribed time, the person presenting it must treat the bill as dishonored by nonacceptance or he loses the right of recourse against the drawer and the indorsers. A bill is dishonored by nonacceptance:

1. When it is duly presented for acceptance and such an acceptance as is prescribed by the Act is refused or cannot be obtained; or

2. When presentment for acceptance is excused and the bill is not accepted.

Presentment for Acceptance Excused. Presentment for acceptance is excused and a bill may be treated as dishonored by nonacceptance in any one of the following cases:

1. Where the drawee is dead, or has absconded, or is a fictitious person not having capacity to contract by bill;

2. Where, after the exercise of reasonable diligence, presentment cannot be made;

3. Where, although presentment has been irregular, acceptance has been refused on some other ground.

DUE NOTICE OF DISHONOR

Except as herein otherwise provided, when a negotiable instrument has been dishonored by nonacceptance or nonpayment, notice of dishonor must be given to the drawer and to each indorser.

By Whom Given. The notice may be given by or on behalf of the holder, or by or on behalf of any party to the instrument who might be compelled to pay it to the holder, and who, upon taking it up, would have a right to reimbursement from the party to whom the notice is given.

By Agent. Notice of dishonor may be given by an agent, either in his own name or in the name of any party entitled to give notice, whether that party is his principal or not. The agent may give notice to the parties liable on the instrument or to his principal. If he gives notice to his principal he must do so within the same time as if he were the holder, and the principal upon receipt of such notice has himself the same time for giving notice as if the agent had been an independent holder.

To Whom Given. Notice of dishonor may be given either to the party himself or to his agent in that behalf. When any party is dead and his death is known to the party giving notice, the notice must be given to a personal representative, if there is one and if with reasonable diligence he can be found. If there is no personal representative, notice may be sent to the last residence or last place of business of the deceased. Where the parties to be notified are partners, notice to any one partner is notice to the firm even though there has been a dissolution. Notice to joint parties who are not partners must be given to each of them, unless one of them has authority to receive such notice for the others. Where a party has been adjudged a bankrupt or an insolvent, or has made a general assignment for the benefit of creditors, notice may be given to the party himself or to his trustee or assignee.

Form of Notice. The notice may be in writing or merely oral, and may be given in any terms which sufficiently identify the instrument and indicate that it has been dishonored by nonacceptance or nonpayment. It may in all cases be given by delivering it personally or through the mails. A written notice need not be signed, and an insufficient written notice may be supplemented and vali-

dated by a verbal communication. A misdescription of the instrument does not vitiate the notice unless the party to whom it is given is in fact misled thereby.

When Notice Must Be Given. Notice may be given as soon as the instrument is dishonored, and unless delay is excused, must be given as follows:

Where the person giving and the person to receive notice reside in the same place, notice must be given within the following times:

1. If given at the place of business of the person to receive notice, it must be given before the close of business hours on the day following dishonor;

2. If given at his residence, it must be given before the usual hours of rest on the day following dishonor;

3. If sent by mail, it must be deposited in the post office in time to reach him in usual course on the day following dishonor.

Where the person giving and the person to receive notice reside in different places, the notice must be given within the following times:

1. If sent by mail, it must be deposited in the post office in time to go by mail the day following the day of dishonor, or if there is no mail at a convenient hour on that day, by the next mail thereafter;

2. If given otherwise than by mail, then within the time that notice would have been received in due course of mail if it had been deposited in the post office within the time specified in the preceding subdivision.

Chain Method of Giving Notice of Dishonor. It is desirable that all notices of dishonor be mailed simultaneously by the holder. However, the law provides that a party receiving notice of dishonor has, after receipt thereof, the same time for giving notice to antecedent parties that the holder has after the dishonor. If the holder, relying on this provision, notifies only the last indorser, he takes the risk that each indorser will transmit the notice within the

prescribed time. If any indorser exceeds the allotted time, his delay cannot be made up by diligence of prior indorsers, and the holder will have failed to perfect his right of recourse against all indorsers prior to the dilatory party. These notices must be "served hot off the griddle."

Notice Duly Mailed Presumed to Have Been Received. Where notice of dishonor is duly addressed and deposited in the post office, the sender is deemed to have given due notice, notwithstanding any miscarriage in the mails. Notice is deemed to have been deposited in the post office when deposited in any branch post office or in any letter box under the control of the Post Office Department. Where a party has added an address to his signature, notice of dishonor must be sent to that address; but if he has not given such address, then the notice must be sent as follows:

1. Either to the post office nearest to his place of residence, or to the post office where he is accustomed to receive his letters; or

2. If he lives in one place and has his place of business in another, to either place; or

3. If he is sojourning in another place, to the place where he is sojourning.

But where the notice is actually received by the party within the time specified above, it will be sufficient, though not sent in accordance with the requirements of this section.

Excuses for Non-Diligence. Notice of dishonor is dispensed with when, after the exercise of reasonable diligence, it cannot be given to or does not reach the parties sought to be charged. Delay in giving notice of dishonor is excused when the delay is caused by circumstances beyond the control of the holder and not imputable to his default, misconduct, or negligence. When the cause of delay ceases to operate, notice must be given with reasonable diligence.

Waiver. Notice of dishonor may be waived, either before the time for giving notice has arrived or after the

omission to give due notice, and the waiver may be expressed or implied.

When Notice of Dishonor Not Required to Be Given. Notice of dishonor is not required to be given to the drawer where he is also the drawee or the person to whom the bill is presented for payment, where the drawee is fictitious or incompetent, or where he has no right to expect or require that the drawee or acceptor will honor the instrument, or where he has countermanded payment; nor is it required to be given to an indorser who indorsed knowing that the drawee was fictitious or incompetent, or where the instrument was made or accepted for his accommodation or was presented to him for payment.

PROTEST

Protest, in the broad sense, implies or includes:

(a) Due presentment of the instrument for payment or acceptance by a notary public;

(b) Dishonor;

(c) Due notice of dishonor given by the notary public to parties secondarily liable (drawer and indorsers);

(d) Due noting: a notation made by the notary public on the face of the instrument and on the day of dishonor, reciting the reason given ("insufficient funds," "account closed") and signed or initialled by the notary;

(e) Certificate of protest. This is a formal extension of the memorandum made by the notary public on the face of the bill. Such extension is on a separate paper and may be made at any time subsequent to noting. It must be annexed to the bill, or must contain a copy thereof, and must be under the hand and seal of the notary making it, and must specify:

(1) The time and place of presentment;

(2) The fact that presentment was made and the manner thereof;

(3) The cause or reason for protesting the bill;

(4) The demand made and the answer given, if any, or the fact that the drawee or acceptor could not be found. (Where notice of dishonor has been given before a formal certificate of protest has been executed, a recital to that effect is ordinarily included in the certificate.)

Protest, in the narrow sense, refers to this certificate of protest and does not embrace the antecedent steps which are included in the broad meaning of the term. If not

made by a notary, protest may be made by any respectable resident of the place where the bill is dishonored, in the presence of two or more credible witnesses. The certificate of protest is admissible as prima facie evidence of the truth of the recitals contained therein as to demand and notice of dishonor, and thus facilitates proof that the necessary steps were taken to fix the liability of parties secondarily liable. If the truth of the recitals in the certificate is properly challenged, the notary public must appear in person on the trial of the action as a witness, his credibility, like that of any other witness, being open to question.

When Protest Required. Where any negotiable instrument has been dishonored, it may be protested for nonacceptance or nonpayment, as the case may be; but protest is not required, except in the case of foreign bills of exchange (a foreign bill is one appearing on its face not to be "both drawn and payable within this state"). Where a foreign bill appearing on its face to be such is dishonored by nonacceptance it must be duly protested for nonacceptance, and where such bill which has not previously been dishonored by nonacceptance is dishonored by nonpayment it must be duly protested for nonpayment. If it is not so protested, the drawer and indorsers are discharged.

Waiver of Protest. A waiver of protest is deemed to be a waiver not only of formal protest but also of presentment and notice of dishonor. The words "Waiving Protest" appearing on the face of the instrument constitute such waiver. If these or similar words appear on the reverse of the instrument, they may be held applicable only to the indorser whose signature appears immediately below them.

WARRANTIES OF INDORSER

On the sale of goods there is an implied warranty that the seller has good title and there may be, in addition, an implied warranty that the goods are of merchantable quality or fit for a certain purpose. Similarly, one who indorses a negotiable instrument impliedly warrants his title and certain other matters. Even the qualified indorser who does

not guarantee payment of the instrument may, nevertheless, incur liability for breach of one or more of the implied warranties. And although the general indorser's obligation to pay the instrument may never become absolute because of non-presentment or omission to give due notice of dishonor, he may nevertheless be held liable if there has been a breach of implied warranty. His liability as warrantor is distinct from his liability to pay the instrument. No steps (due presentment, due notice of dishonor, protest) are necessary to fix an indorser's liability for breach of warranty.

Implied Warranties of Qualified Indorser. Every person negotiating an instrument by delivery or by a qualified indorsement warrants:

1. That the instrument is genuine and in all respects what it purports to be. (D indorses a $500 check to P "without recourse." The check was originally drawn for $50 and had been raised to $500, but this was not known to D or P. P took the check for value and satisfied the requirements of a holder in due course. P can recover a judgment against the drawer in the amount of $50, and a judgment against D in the amount of $450 for breach of the warranty of genuineness. Note that D is liable notwithstanding the fact that he had no knowledge of the forgery.)

2. That he has good title to it.

3. That all prior parties had capacity to contract. (D for value transfers a bearer note to P without any indorsement whatsoever. The maker is an infant, which fact was not known to either D or P. P can obtain a judgment against D for breach of D's implied warranty as to the capacity of the maker. But D is liable only to P — D's immediate transferee — as D did not indorse. If D had indorsed "without recourse," D would be liable not only to P, but to all subsequent holders.)

4. That he has no knowledge of any fact which would impair the validity of the the instrument or render it valueless. (D, knowing that a note is invalid for want of con-

sideration, indorses it "without recourse" to P for value. P does not know of the defense, but takes the note after maturity, and hence is not a holder in due course. P sues the maker, who defends on the ground of no consideration. P notifies D of the pending suit and gives D an opportunity to control the litigation. P loses his case against the maker. P can now enforce D's liability for breach of warranty. Similarly D would be liable in warranty if he indorsed "without recourse" a note which he knows to be invalid for usury or illegality.) However, a qualified indorser does not warrant the solvency of prior parties, and cannot be held liable (in the absence of bad faith or active concealment) in the event of the maker's insolvency. A qualified indorsement has been held to entail liability for breach of warranty extended by analogy to facts not directly within any one of the four warranties enumerated above. (D indorses a note "without recourse" to P. The note is secured by a lien. D, after indorsing to P, releases the lien. If P fails to collect from the maker, P can collect from D. The court grounds the recovery on an implied warranty by D that he will do no act to prevent P from collecting the note.)

Implied Warranties of the General Indorser. The general indorser also warrants title, genuineness, and capacity of prior parties — in terms identical with those of the qualified indorser as set forth in (1), (2), and (3) of the preceding section. In place of (4), however, the general indorser warrants: "that the instrument is at the time of his indorsement valid and subsisting." Hence, in the examples given in (4) above, if D had indorsed without qualification, he would be liable to P even if he had no knowledge as to the defect or infirmity in the instrument.

Sale of Public or Corporate Securities. Brokers and other persons "negotiating public or corporate securities, other than bills and notes" do not warrant the capacity of prior parties. (Under authority of acts of the legislature of Kansas, the city of Topeka issues bonds. The D bank buys some of these bonds and sells some to P, an investor. The Supreme Court of the United States subsequently de-

cides that the legislature of Kansas had no power to pass the acts authorizing the issue of the bonds and that the bonds are void. D is not liable to P for breach of implied warranty. D did not impliedly warrant that the city of Topeka had the capacity to issue the bonds in question.)

Warranties of Restrictive Indorser. Writing one's name on the back of a check upon presentment for payment does not warrant to the drawee bank the genuineness of the holder's signature or the genuineness of prior indorsements, since the bank is not to purchase or become the holder or transferee of the instrument, but to pay it (whereupon it is extinguished and becomes merely a voucher). Such writing is not an indorsement under the law merchant. Nevertheless, it has been held that a restrictive indorser ("for collection") impliedly warrants that the instrument is genuine and that he has good title to it. Where a drawee bank receives or pays a check which is restrictively indorsed, it may protect itself by insisting that the transferor add to the restrictive indorsement the words: "Previous indorsements guaranteed." It has been held that the right of the drawer (as well as the right of the holder) to have the bill paid according to its terms is violated by the drawee's refusal to pay a bill (at maturity) except upon "indorsement" by the person presenting it for payment.

Chapter XXXII

HOLDERS IN DUE COURSE

Before reading this chapter, read again the introductory matter (pp. 165 f.) so that you will have in mind, in a general way, the importance of determining whether a plaintiff (in an action on a negotiable instrument) has the status of a holder in due course.

DEFINITION OF HOLDER IN DUE COURSE

A holder is a payee or indorsee of a bill or note who is in possession of it or is the bearer thereof. A holder in due course is a holder who took the instrument under the following conditions:

1. That it is complete and regular upon its face;

2. That he became the holder of it before it was overdue and without notice that it had been previously dishonored (by nonacceptance), if such was the fact;

3. That he took it in good faith and for value;

4. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

"Complete and Regular upon Its Face." An instrument payable "on or before . . . after date" is not complete and regular; the same has been held (with far less plausibility) as to a trade acceptance dated August 1, 1919, payable "December 1" (not naming the year); and it has been held that an instrument drawn by A to the order of B, naming no drawee, with a purported acceptance signed by D, written across its face and reciting that "this obligation arises out of the actual purchase of goods from the drawer" is not complete and regular in view of the blank for the

drawee's name. An instrument having the figures in the upper left hand corner and a blank space for the amount in words is complete and regular on its face, since the court can ascertain, within the four corners of the instrument and excluding nothing there appearing, the terms and conditions of the obligation.

"Before It Was Overdue."

1. Time Paper. So far as his direct rights are concerned, a transferee of time paper after its fixed maturity is not a holder in due course and takes subject to all defenses, personal as well as real (when bearer bonds of P were stolen before maturity and purchased by D in good faith after maturity, D got no title: it did not appear [and there was no presumption] that the thief negotiated them to any bona fide holder before maturity). One taking a negotiable instrument after the maturity of an instalment of principal (with actual or constructive notice that it is unpaid) is not a holder in due course.

2. Demand Paper. Where an instrument payable on demand is negotiated an unreasonable length of time after issue, the holder is not deemed a holder in due course. The maturity of demand paper is important in three respects: (1) When is it overdue so that one taking it is not a holder in due course? (2) When is it too late to present it for payment for purposes of charging parties secondarily liable? (3) When does the Statute of Limitations begin to run? As to the first question, the expression "reasonable time" cannot (aside from usage) be fixed with precision except in reference to the circumstances of the particular case showing the intention, expectation, and agreement of the parties. It has been held that the lapse of twenty-four days from the date a check was issued does not per se give it the appearance "of a dishonored draft or of an overdue and unpaid promissory note," and that more than two years is not too long in the case of a demand note that was to "lie so long as the payees were satisfied with it." As to the second question, see Chapter XXXI. As to the third question, demand paper (whether or not drawing interest) is

actionable *without demand* immediately upon its issue; and the Statute of Limitations, therefore, begins to run as soon as the maker or acceptor is so bound. (However, the weight of authority before the N.I.L. was adopted required a preliminary demand before action could be brought on a *certificate of deposit.* [Under the N.I.L. this has been held in at least one case to be unnecessary, but it cannot be said that the rule under the N.I.L. is settled.] Just as the Statute of Limitations does not begin to run against an ordinary bank deposit until a demand for payment is made, so it had been held that a demand was necessary to start the statute running against a certificate of deposit.)

Good Faith. P (the person to whom the instrument is negotiated) may not have actual knowledge of any infirmity therein or of any defect in the title of the negotiator; yet P may take the instrument in bad faith. P, purchasing a note without knowledge of specific facts but after being told that the maker intends to resist payment or that the transferor had no legal right to transfer (though honestly believing that the law would sustain the transfer), or purchasing it without inquiry into a canceled indorsement, has been held not a holder in due course. Similarly, there may be an issue of fact as to P's good faith where he pays $6,750 for notes aggregating $27,000 (the makers being financially responsible). However, high — or even usurious — discount does not necessarily prevent one's being a bona fide holder. It is evidence, to be considered in the light of all other relevant circumstances, on the issue of good faith. In some courts actual suspicion (and, generally, taking with notice that there is something wrong, without notice of the particular wrong) prevents P from being a holder in due course; but it would seem the better rule that neither knowledge of suspicious circumstances, nor reasonable cause to know that the facts were not as represented by the transferor, nor doubts as to the genuineness of the title, nor gross negligence on the part of P, singly or together, are sufficient to defeat P's recovery unless amounting to proof of bad faith. (That P was negligent

or forgetful as to an earlier notice that certain bonds acquired by P had been stolen does not necessarily prevent P's being a holder in due course.)

Nonpayment of interest is not in law dishonor of a negotiable instrument, but is a fact to be considered on the issue of good faith.

1. **Corporate Paper Used to Pay Personal Debts.** Most courts hold that one is put on inquiry by an instrument to the order of A (or to a third person) made or drawn by "D corporation by A, treasurer," and negotiated (as P does or should know) for A's individual advantage. It is also held that while the question of holding in due course is one of fact in such a case, if corporate paper is payable to the creditor (so that it is on its face a misappropriation of corporate funds to pay an individual debt) the latter cannot, as a matter of law, be a holder in due course.

2. **Knowledge that D Signed for Accommodation.** P's knowledge that D (an individual person) signed for accommodation does not prevent P's being a holder in due course, but if D were a corporation and if its signature were not only an accommodation signature (as P knew) but *ultra vires* as well, then P (though a holder in due course) could not hold D thereon. P, having actual knowledge of the accommodation character of the D corporation's signature is charged with constructive notice of the fact that it was *ultra vires.* Similarly a note made by A to the order of B, indorsed "D & Company by A" (for B's accommodation without D's consent, A and D being members of D & Company) and then endorsed by B to P, carries notice from its form to P (a bona fide taker before maturity, and without actual notice) that it is prima facie for accommodation; and so he cannot hold D.

3. **Recital of Executory Consideration.** An instrument reciting executory consideration is negotiable, and one taking it for value before maturity without notice that the consideration has failed may be a holder in due course; he need not follow the transactions between the original parties, or await the consummation of the transaction giving rise to the instrument.

4. **Antedated and Postdated Instruments.** One to whom an antedated or postdated instrument is delivered acquires title thereto as of the date of delivery; the instrument is not invalidated by antedating or postdating not done for an illegal or fraudulent purpose. Strictly speaking, a "postdated check" is neither a check (because not payable on demand) nor an ordinary bill of exchange (which may be presented for acceptance, with immediate right of recourse against parties secondarily liable in case of dishonor). It is (by the weight of authority) negotiable (and may thus come into the hands of a holder in due course) from the time of issue and before the date written. P (holder in due course of a postdated check) may therefore maintain suit against D (drawer) notwithstanding that D had a defense good as against A (payee).

Value. The law merchant was not concerned with consideration. Mercantile instruments were binding (and were sustained in the mercantile courts) by their own force.

When, however, the question of their enforcement came up in the common law courts, the judges treated them as another form of specialty (analogous to the instrument under seal, which "imported" consideration) and proof of execution together with production made out a prima facie case.

Every negotiable instrument is deemed prima facie to have been issued for a valuable consideration, and every person whose signature appears thereon to have become a party thereto for value. Value is any consideration sufficient to support a simple contract; but where the transferee receives notice of any infirmity in the instrument or defect in the title of the person negotiating the same before he has paid the full amount agreed to be paid therefor, he will be deemed a holder in due course only to the extent of the amount theretofore paid by him. While a "mere executory promise to pay an agreed price" is not value for the transfer of a negotiable instrument, the drawer of a negotiable check (P) delivered in good faith in exchange for a negotiable note made by D (before the maturity of the latter and without notice of an infirmity or defect therein) may be found to have given value as of the time of such delivery, notwithstanding receipt of notice of an infirmity or defect in the note before the check is paid by the drawee; from this point of view the giving of a negotiable instrument is the same as the giving of cash because each instrument is an independent obligation not conditioned on payment of the other, and it has even been held that P is not bound to stop payment on his check upon discovery of an infirmity in the other instrument or defect in the title of the person negotiating it. Where value has at any time been given for the instrument, the holder is deemed a holder for value in respect to all parties who became such prior to that time.

1. **Antecedent Debt Is Value.** In nearly all courts the mere taking of a negotiable instrument as security for an antecedent debt (whether matured or not) is value, as is mere satisfaction (absolute or conditional) of all or part of an antecedent debt.

2. **Where Holder Has a Lien on the Instrument.** Where the holder has a lien on the instrument (arising either from contract or by implication of law) he is deemed a holder for value to the extent of his lien. An indorsee (P), holding as collateral security

for an obligation running to P from A (indorser) an instrument on which D is bound, and being a holder in due course thereof, is entitled to recover the whole amount of the instrument unless D has a defense against A, in which case P (though holder in due course) recovers only the amount for which the instrument was held as security. (A, maker of a note indorsed by D for his accommodation, misapplied it by wrongfully transferring it as collateral to P before maturity. A later paid part of his debt. P, though acting throughout in good faith and giving value, can recover as against D only the amount of the debt due him.)

3. **Deposits and Discounts.** Where A deposits items for collection to the credit of his account in P bank (whether such items are restrictively indorsed or not), P is not a purchaser for value merely because P has provisionally credited such items to A's account in anticipation of their actual collection. So long as A's deposit is intact and so long as P has not absolutely bound itself to account for the amount or given value aside from the obligation created by accepting the items for collection, P will not be deemed to have given value. But P is held to have given value if the entire deposit is withdrawn by the bank having honored checks to the full amount of the deposit as it stood at the time of depositing the paper (and including the proceeds thereof, but not subsequent deposits) or where the credit is applied to the payment of a debt due from A to P: the courts are not agreed as to whether or not the bank has given value if any substantial portion less than all of the deposit has been withdrawn. Checks presented are taken as paid from the earliest deposits ("first in is first out"). Thus:

September 5:	Credit Balance	$ 295.08;
6:	Note due Sept. 11, discounted for credit	1,241.90;
7:	Deposit	1,000.00;
	Checks paid left balance at close of business	209.63;

Held: P was a holder in due course.

HOLDER UNDER HOLDER IN DUE COURSE

A holder (P) who derives his title through a holder in due course (B), and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of B in respect of all parties prior to B. (D is induced by A's fraud to sign and deliver his promissory note to A. A negotiates the note to B, a holder in due course. B, after maturity, indorses the note to C; and C indorses the note to P, who knows that it was obtained by fraud. P can, nevertheless, enforce D's liability on the note. P is not a holder in due course, but he can trace his title through B; and, accordingly, P enjoys the benefit of B's position. P's knowledge of the fraud is immaterial, as he did not have any part in it.

[This is the majority rule; there is authority to the effect that one is guilty of fraud if he takes or negotiates with notice thereof.])

Reacquisition. Assume that in the preceding illustration P, after assisting A to defraud D, had acquired the note directly from A (the payee). Subsequently, the note is negotiated to B, a holder in due course. At maturity the note is not paid by D, and P takes it up. Under the circumstances P cannot enforce D's liability. P is remitted to his original position which he occupied when he first acquired the note from A. P will not be permitted (on reacquiring the note) to "shelter himself" behind the rights of C, the holder in due course. However, a holder in due course who transfers the instrument with a guaranty of payment and reacquires it (to protect his guaranty) under circumstances imputing knowledge of an infirmity does not lose his original position as holder in due course. The original status of the holder determines his rights, not his status at the time of reacquisition.

PAYEE AS HOLDER IN DUE COURSE

In most states the payee may be a holder in due course, if the payee is disconnected with the transaction which gave rise to the instrument. (A in New York, purchases from the X bank its check drawn on the Y bank in Chicago payable to the order of B, A's creditor. A mails the check to B. B, although payee, would generally be treated as a holder in due course.)

EVERY HOLDER PRESUMED TO BE A HOLDER IN DUE COURSE

Every holder is deemed prima facie to be a holder in due course. (P sues D on a promissory note made by D payable to the order of A and by A indorsed to P. P is presumptively a holder in due course, but if D offers evidence [which is believed] that A obtained the note by fraud, P can no longer rely on the presumption in his favor but must introduce evidence to establish that he satisfies each of the requirements of a holder in due course.)

TRANSFER OF ORDER PAPER WITHOUT INDORSEMENT

Where the holder of an instrument payable to his order transfers it for value without indorsing it, the transfer vests in the transferee such title as the transferor had therein, and the transferee acquires, in addition, the right to have the indorsement of the transferor. But for the purpose of determining whether the transferee is a holder in due course the negotiation takes effect as of the time when the indorsement is actually made.

When an instrument is handed over for valuable consideration, the indorsement is a mere form; the transfer for consideration is the substance, creating an equitable right and giving the transferee the right to call for the doing of the formal act necessary to substantiate that right. The N.I.L. (changing the previous rule whereby a transfer without indorsement conveyed merely an equitable title and destroyed the negotiability of the instrument) provides that such legal title as the transferor had is in the transferee, together with the right (in the absence of other agreement) to have the indorsement of the transferor in order to preserve the negotiability of the paper and to make him liable (it has been held) as indorser without qualification. Until the indorsement is actually put on, however, the transferee is merely an assignee of an ordinary chose in action and cannot be treated as a holder in due course. If the indorsement is not actually put on until after maturity, it does not (except as to an equity outside the instrument itself) relate back, and the holder takes subject to personal defenses available to a prior party before the indorsement is actually made.

NEGOTIATION AFTER MATURITY

An overdue instrument is still negotiable, and although (in the hands of one who neither is, nor makes title through, a holder in due course) it is subject to defenses existing at the time of transfer, it is certainly not "subject to the same defenses as if it were nonnegotiable." Thus payment

by D (maker) to A (payee), of a past due note after its negotiation by A to P after maturity, is no defense to an action by P, since D made the instrument negotiable and cannot rightly assume that it has not been transferred. (The result would of course be different were the note a non-negotiable chose in action or had the payment been made [after maturity but] prior to the transfer by A.) Maturity, however important in relation to the indorser's contingent contract to pay the instrument, is inconsequential if we consider an indorsement as a conveyance of the legal title to an instrument regarded as a species of property. Accordingly, one acquiring the legal title to the instrument in good faith and for value (even after maturity) is protected against latent equities respecting it. Such a bona fide purchaser of a negotiable instrument (D) from one having apparent legal title thereto (A) may claim the benefit of estoppel as against P who clothed A with the indicia of ownership.

Chapter XXXIII

REAL AND PERSONAL DEFENSES

IMMEDIATE, REMOTE, AND PRIOR PARTIES

1. **Immediate Parties.** Assume that A makes and delivers his promissory note to B (payee), and that B indorses to C, and C to D. AB are said to be immediate parties, because they are in direct contractual relation with each other.[1] The same is true of BC and CD; therefore BC and CD are also immediate parties.

2. **Remote Parties.** In the preceding illustration AD are remote parties — that is, parties who were not in direct contractual relation with each other. Other pairs of remote parties are : AC, BD.

3. **Prior Parties.** In the illustration given in (1) above, ABC are prior parties with respect to D.

REAL DEFENSES

A *real* or *absolute* defense is one that is good against any holder, including a holder in due course (maker's defense that he was an infant when he executed and delivered the instrument sued on). A *personal* defense (sometimes called an *equity*) is available to prior parties among themselves, but is not good against a holder in due course (maker's defense of want of consideration). The Negotiable Instruments Law coyly refrains from distinguishing in terms between real and personal defenses. Real defenses include: nondelivery of an incomplete instrument, want of authority, forgery, material alteration, incapacity (but the law of each state must be examined as to the effect of insan-

1 Where, however, A makes and delivers to X (an intermediary) his (A's) promissory note payable to the order of B, and X delivers the note to B (payee) for value, A and B are not immediate parties. Immediacy signifies privity, not mere proximity.

ity, coverture, and complete intoxication [in some states]), fraud in the essence of the contract (fraud in the factum: signing an instrument in nonnegligent reliance upon an assurance that it was a contract of an entirely different kind), some kinds of illegality (depending on the statutes involved, and including, ordinarily, usury and gambling acts) and an *ultra vires* signature by a corporation as accommodation party (if the holder took with notice that the signature was for accommodation). Speaking generally, therefore, negotiability means that (1) if the instrument is negotiable, and (2) if it is in the hands of a holder in due course or of one (not a holder in due course) deriving his title through a holder in due course and not himself a party to any fraud or illegality affecting the instrument, then (3) he holds it free from personal defenses available to prior parties as between themselves, and subject only to the real defenses just enumerated. We shall now consider each of these in some detail.

Nondelivery of an Incomplete Instrument. In order that the circulation of negotiable instruments, as part of the mercantile currency of the country, may not be impeded, there is not only a conclusive presumption in favor of a holder in due course that all prior parties upon an instrument in his hands made valid delivery thereof, but also a presumption of fact that a party whose signature appears upon an instrument no longer in his possession made valid and intentional delivery thereof. (An instrument, in form a note, on which the maker [D] was about to insert a condition [insuring delivery of the property for which the note was given, as a condition precedent to its validity], snatched from him by the payee and negotiated to P [a holder in due course], is enforceable by the latter). It is this conclusive (non-rebuttable) presumption of delivery that protects one who buys stolen negotiable securities, provided, of course, he buys for value and in good faith and before maturity, and is a holder in due course. But this presumption applies only to completed instruments. It does not apply to an incomplete instrument which has not been

delivered. If such instrument is completed and negotiated (without authority), even a holder in due course will be unable to subject to liability any person whose signature was placed thereon before delivery. (D signs a check in blank and leaves it on his desk. A, wrongfully takes the check, fills it in, and indorses it to P, a holder in due course. If D stops payment, and P sues D, judgment will be for D. [However, if D had not succeeded in stopping payment, the drawee bank (X) would probably be justified in charging the check to D's account. As between D and X, if any loss is occasioned by signing checks in blank, the loss falls on the depositor and not on X. But even if the check had been paid, D could sue to recover the proceeds of the check on the theory that P would be unjustly enriched if he were permitted to retain the money.]) Carelessness in keeping an incomplete instrument may estop a defendant from setting up that it was not delivered.

Want of Authority. Where an agent (A) has signed an instrument on behalf of his principal (P), P is liable to no one (not even to a holder in due course) unless A had actual or apparent authority to sign P's name. True, where the instrument is wanting in any material particular the person in possession thereof has prima facie authority to complete it by filling up the blanks therein, and a signature on a blank paper (delivered by the person making the signature, in order that the paper may be converted into a negotiable instrument) operates as a prima facie authority to fill it up as such for any amount. In order, however, that any such instrument when completed may be enforced against any person who became a party thereto prior to its completion, it must be filled up strictly in accordance with the authority given, and within a reasonable time. But if any such instrument, after completion, is negotiated to a holder in due course, it is valid and effectual for all purposes in his hands, and he may enforce it as if it had been filled up strictly in accordance with the authority given and within a reasonable time. (D signs and delivers to A a note with the amount blank, authorizing A to fill in an

amount not over $500. D owes A $550, and A accordingly fills in this amount. It has been held that A cannot enforce the note for any amount. If, however, after such completion A indorses the note to P, a holder in due course, P can hold D liable for the face amount, $550.) Under the N.I.L. one taking an incomplete instrument before maturity in good faith and for value can no longer complete it in accordance with the representations of the person from whom he took it: he is (as against anyone becoming a party thereto prior to its completion) held to the actual authority given. Thus P, taking a note signed by D in blank and entrusted to A (comaker) to be filled up for the amount A owed P on a certain account (about $1,900), and filling it up for $4,561.39 (the amount of A's general indebtedness to P), was put on inquiry as to A's authority to complete the note "regardless of what A may have said" at the time he delivered the note to P; and in P's hands the note was, therefore, invalid as to the entire amount.

Insertion of Date. Where an instrument expressed to be payable at a fixed period after date is issued undated, or where the acceptance of an instrument payable at a fixed period after sight is undated, any holder may insert therein the true date of issue or acceptance, and the instrument shall be payable accordingly. The insertion of a wrong date does not avoid the instrument in the hands of a subsequent holder in due course; but as to him the date so inserted is to be regarded as the true date (but it has been held that the insertion of a wrong date in an undated instrument by one having knowledge of the true date of issue will avoid the instrument as to him.)

Forgery. Where a signature is forged (as where it is made without the authority of the person whose signature it purports to be), it is wholly inoperative; and no right to retain the instrument, or to give a discharge therefor, or to enforce payment thereof against any party thereto, can be acquired through or under such signature, unless the party, against whom it is sought to enforce such right, is precluded from setting up the forgery or want of authority.

The duty of care in preparing checks owed by the drawer to the drawee has been stated in terms of the contract duty of the banker to pay checks duly signed by the drawer having funds available, if the appearance and contents of the check present no reasonable ground for suspicion. Most

courts hold that the drawer is under a duty to his bank to examine returned checks, passbooks, and statements of account within a reasonable time, in order to discover forgery and alteration and to give notice of them. This duty, however, does not ordinarily require an examination of indorsements in order to determine their genuineness as the drawer may be in no better position than the drawee to make such determination. (A Massachusetts statute requires notice of forgery, want of authority, or material alteration to be given in writing by drawer to drawee bank within one year after the return of the instrument to the former. New York has a similar one-year statute with regard to forgery of the drawer's signature, and a two-year statute with regard to forged indorsements.)

1. **Impersonation.** Where an instrument payable to the order of A is handed by the maker or drawer (D) to B with intent to deliver it to the person then before him (whom, after inquiry, he believes to be A) and B forges A's name as indorser and the instrument comes into the hands of P (a holder in due course), D's dominant intent is held to be to deal with the person (B) identified by his visible presence (the "surest means of identification"), and B's indorsement (in the name of A, as B was designated in the transaction) is therefore effective. Much less plausibly courts of high standing have reached the same result where the instrument has been indorsed by another person (X) of the same name (A) into whose hands it has come through misdelivery to which D's negligence proximately contributed. On the other hand, where P drew on D bank a draft to his own order and endorsed specially to A (for whom B, a lawyer, falsely represented to P that he wanted a loan on a mortgage of land which B in fact owned), he may recover from D bank the amount paid by the latter upon the draft (handed by P to B), as distributed without P's authority, where the signature of A (a nonexisting person) was forged. Similarly, where A was already known to maker or drawer (or was more particularly identified by him by designation, description, or title) or where neither he nor his agent had any dealings or communications of any kind with the impostor until he appeared (and then delivery was authorized, not to the impostor, but to the person whose identity he simulated)—his dominant intent is held in all these cases to be that the instrument be paid to the person he thinks the impersonator is. This last situation is to be distinguished from a case in which delivery is made to the impostor as the consummation of earlier dealings or negotiations (in the course of which the impostor deceived D as to his name and identity) and with intent that the instrument be paid to the person with whom they were carried on, even though he was designated by a name he did not bear. Doubt in the mind of D as to whether or not the person to whom he delivered the instrument is masquerading does not mean that he must at his peril determine the identity. Commercial and legal theory tends

more and more to disregard everything except what actually appears on the instrument; only thus can merchants rely on the rule that a negotiable instrument, in the hands of an innocent purchaser, will be paid according to its terms and intent and not otherwise. Where, instead of impersonating A, B falsely represents himself to be the agent of A and so secures a check to the order of A, his indorsement of the instrument in A's name is manifestly a forgery, whether or not A is an existing person.

2. **Fictitious Payee.** When an instrument is payable to the order of a fictitious or nonexisting person, and such fact was known to the person making it so payable, it is payable to bearer. A fictitious person within this rule is a person whose name is intended and used by a maker or drawer executing the instrument as that of one who should never receive the instrument or have any right thereto or to its proceeds, the name being inserted as a matter of form, with intent that the instrument should not be payable to a particular person but to anyone having possession with or without the indorsement of the designated payee. If an employee (A) with authority from D to draw negotiable paper does so to the order of a fictitious or nonexisting person, it is bearer paper (although by an amendment to the Illinois statute the fictitious character or nonexistence of the payee must be known not only to A but to D as well): but if A (not having authority to draw negotiable paper) procures his employer (D) unwittingly to sign paper to the order of such a payee, and then he (A) forges the payee's name, it is still order paper. If a person bearing the name of the designated payee in fact exists, and the maker or drawer (with knowledge thereof) intends that he shall receive and negotiate it (whether or not he has in fact an interest in the transaction) the instrument is order paper. The same is true if (although no person bearing that name has in fact any interest in the transaction) the maker or drawer thinks such a person does exist and has an interest in the transaction, and intends him to receive and negotiate the instrument. We have seen already that making an instrument payable to an impersonal payee—whose indorsement is obviously impossible—manifests an intent that it be bearer paper, negotiable by delivery.

Material Alteration. Where a negotiable instrument is materially altered (even for the purpose of correcting an error) without the assent of all parties liable thereon, it is avoided, except as against (1) a party who has himself made, authorized, or assented to the alteration, and (2) subsequent indorsers (this is so if the identity of the contract is destroyed, whether the alteration is injurious or beneficial to the obligor: as where the amount payable was changed from $500 to $400). But when an instrument has been materially altered and is in the hands of a holder in due course, not a party to the alteration, he may enforce payment thereof according to its original tenor. Courts are divided as to the extent of D's liability where he signs an

instrument (complete in all respects and without blanks at the time of delivery but with obvious uncanceled spaces left by D) which is thereafter fraudulently raised by A and negotiated to P, a holder in due course. New York, Maryland, Massachusetts, Texas, and some other states hold that D's negligence in signing such an instrument is not the proximate cause of the loss by forgery or alteration, and accordingly limit P's recovery to the original amount. Other courts permit a recovery for the raised amount.

WHAT ALTERATIONS ARE MATERIAL. Any alteration which changes (1) the date; (2) the sum payable, either for principal or interest; (3) the time or place of payment; (4) the number or the relations of the parties; (5) the medium of currency in which payment is to be made; or which adds a place of payment where no place of payment is specified, or makes any other change or addition which alters the effect of the instrument in any respect, is a material alteration.

Before the N.I.L. a material alteration (whether or not injurious to the obligor) avoided the instrument (as to parties then thereon) even in the hands of a subsequent holder in due course, for the reason that the changed instrument was no longer the identical contract made by the obligor. An innocent alteration made in good faith after delivery to correct an actual or supposed mistake has been held (although the decisions are not uniform) to avoid the instrument, but not to discharge or satisfy the original debt not extinguished by its execution (as would have followed from a fraudulent alteration). It is not clear on the authorities whether or not alteration in the N.I.L. includes spoliation (a material change by a stranger who neither is nor has authority from obligor or obligee).

Incapacity. An infant's obligation upon a negotiable instrument is voidable by him (or by his heirs or personal representatives and probably by his guardian) even if it was given for necessaries and even if it was in the hands of a holder in due course. This privilege of avoidance is, however, personal and cannot be exercised by his creditors

or trustee in bankruptcy, or by other persons collaterally interested. His indorsement, while not operating as a guarantee of payment, is nevertheless effectual to pass title to the instrument. The similar disability of a married woman (like the right of the husband to realize upon his wife's rights in general, including those in negotiable instruments) has almost entirely disappeared, except for her inability (in some states) to bind herself as surety for her husband (or, in some states, for anyone), and for the complete inability of either spouse in some states to assume a binding obligation in favor of the other.

The rules as to the liability of the insane person as party to negotiable instruments are not so clear. It has generally been held that he is not liable on a signature for accommodation, but the courts are not in accord as to whether or not a signature by a lunatic (incapable of understanding the nature and quality, and not grasping the significance, of the transaction) is voidable as against one acting fairly and without actual or constructive notice of the incapacity. There is a similar lack of uniformity as to the right of timely disaffirmance by a totally intoxicated person as against a holder in due course.

Ultra Vires. In the hands of a holder in due course an *ultra vires* contract (on a negotiable instrument) of a manufacturing or trading corporation, having general charter authority to execute negotiable paper in the course of its business, is valid even though the instrument was in fact executed for a noncorporate or other improper purpose beyond the scope of that business. However, signing for accommodation of another is not commonly within the power of an ordinary commercial corporation, and if P took the instrument with notice or knowledge that the signature of D corporation was for accommodation, he cannot (though he is a holder in due course) hold D corporation thereon.

Fraud in the Execution (Fraud in the Factum). One signing an instrument under a misapprehension (induced by the payee) that it was an instrument of another character

(so that his mind did not act in the execution of the particular agreement as and for what it purported to be) is not bound thereby, even to a holder in due course: the objection goes back of all questions of negotiability or holders in due course, and challenges the origin or existence of the paper itself as not in law or in fact what it purports to be. Of course, if one signs an instrument without a satisfactory excuse for not reading it or having it read to him, he may be chargeable with negligence giving rise to an estoppel. (A, dealing at arm's length with D, presents to D for signature a paper which A says is a "duplicate order." D signs without reading it. The paper is a negotiable promissory note for $500. A indorses the note to P, a holder in due course. D is liable to P.)

1. Fraud in the Inducement. Fraud in the inducement is a personal defense. (A induces D to purchase stock by fraudulent misrepresentations. D gives his promissory note in payment. If the note is indorsed to a holder in due course, D's defense of fraud in the inducement will be cut off.) Fraud in the execution implies that D did not know what he was signing. Fraud in the inducement implies that D knew what he was signing, but that he was induced by fraud to sign.

2. Duress. Duress (other than physical duress) is a personal defense. The title of a person who negotiates an instrument is defective when he obtained the instrument, or any signature thereto, by fraud, duress, or force and fear, or other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to a fraud.

3. Renewal Note. Does Not Waive Fraud. A renewal note made by D in ignorance of fraud of P (payee) or of partial failure of consideration, as to the original note is no waiver of the defense to the latter.

Statutory Invalidity. Illegality is ordinarily a personal defense not available as against a holder in due course, since one may not assert his own participation in an illegal transaction in defense to suit by an innocent party (thus if D

makes a note to the order of A corporation for a stock subscription which A takes in violation of a legal requirement that stock be paid for in money, labor done, or property actually received, it is enforceable by a holder in due course). If, however, an illegal transaction is made *void by statute,* as are gambling and usury in most states, the illegality is a real defense and P (holder in due course) cannot recover; but the usury laws of each state must be consulted: some make the instrument void (and so entail loss of principal and interest), most preclude the recovery of any interest whatever, while some forbid only the recovery of excessive interest (and in each group some statutes expressly protect holders in due course). In a very few states there are either no usury laws or they are of limited application.

DISCHARGE OF INSTRUMENT

A negotiable instrument is discharged:

1. By payment in due course by or on behalf of the principal debtor. Payment in due course means payment at or after the maturity of the instrument to the holder thereof in good faith and without notice that his title is defective. It is generally held that payment of bearer paper in due course to a thief or a finder is a discharge. Where the maker or acceptor agrees to pay to the payee or to his order, he is bound, if he makes payment, to see that it is made accordingly — that is to say, to the then legal holder of the instrument (whether the payee or the person to whom he has ordered it paid); and it has been said that even a donee-indorsee (P) after maturity may require payment from the maker (D) notwithstanding payment by D to P's indorser (A) after the negotiation to P.

2. By payment in due course by the party accommodated, where the instrument is made or accepted for accommodation.

3. By the intentional cancellation thereof (not necessarily in writing) by the holder. A cancellation made unintentionally, or under a mistake, or without the authority of the holder, is inoperative.

4. By any other act which will discharge a simple contract for the payment of money.

5. When the principal debtor becomes the holder of the instrument at or after maturity in his own right.

6. By the holder's absolute and unconditional renunciation of his rights against the principal debtor made at or after the maturity of the instrument. *But a renunciation does not affect the rights of a holder in due course without notice.* A renunciation must be in writing, unless the instrument is delivered up to the person primarily liable thereon (the person who, by its terms, is absolutely required to pay it). Renunciation means the surrender,

relinquishment, or abandonment of a claim with or without recompense, including a gratuitous waiver as well as a release by accord and satisfaction. The holder may expressly renounce his rights against any party to the instrument, before, at, or after its maturity.

When an instrument is discharged, all parties thereon are likewise discharged from liability.

DISCHARGE OF PERSON SECONDARILY LIABLE

A person secondarily liable on the instrument is discharged:

1. By any act which discharges the instrument.
2. By the intentional cancellation of his signature by the holder.
3. By the discharge of a prior party otherwise than by operation of law. (A makes a note payable to the order of B. B indorses to C, C to D, D to E, and E to F. If F intentionally cancels D's signature, E is automatically discharged. It will be remembered that E is a guarantor. If E were compelled to pay, he would have a right of recourse against prior parties [A, B, C, D]. By the discharge of D, E's right of indemnification has been impaired; hence on strict suretyship principles E must be absolutely discharged notwithstanding the fact that he might sustain no damage where A, B, and C are financially responsible parties.)
4. By a valid tender of payment made by a prior party.
5. By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved.
6. By any agreement binding upon the holder to extend the instrument, unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved.
7. By certification of a check at the instance of the holder (which discharges indorsers and the drawer, too).

The drawer and indorsers are secondarily liable on the instrument. Their liability is similar to that of a surety. On strict suretyship principles action by C (the creditor) or an agreement between C (creditor) and D (the principal debtor) discharges S (the surety) if the effect of such action or agreement is to impair or to suspend the surety's right to indemnification or subrogation. This principle supports rules 3, 4, 5, and 6 above.

Where the instrument is paid by a party secondarily liable thereon, it is not discharged; but the party so paying it is remitted to his former rights as regards all prior par-

ties, and he may strike out his own and all subsequent indorsements, and again negotiate the instrument, except:

1. Where a bill of exchange payable to the order of a third person has been paid by the drawer, and

2. Where an instrument was made or accepted for accommodation and has been paid by the party accommodated.

A bill to the order of a third person, returned to the drawer dishonored, may not then be negotiated by him so as to expose any of the parties otherwise discharged to a new liability thereon, as where D accepted a bill drawn by A to the order of B but dishonored it by nonpayment and it was returned to B and later taken up by A, who assigned it to P: thus P cannot hold D, since the instrument is not negotiable—otherwise a discharged party would be exposed to a new liability. (In order to hold D, P would have to make title through the payee; but the payee is discharged and his indorsement nullified by A's payment.)

LIABILITY FOR WRONGFUL NEGOTIATION

The obligor (P) may hold D in tort, presumptively for full value of the instrument, for wrongfully negotiating an instrument (and thus making P liable) to a holder in due course as against whom P's personal defenses are cut off; and so where D negotiates to A (holder in due course) an instrument on which is an indorsement by P corporation, known to D to be *ultra vires,* creating thereby a liability (not previously existing) on which A recovered judgment against P, P can hold D liable.

Part VI: Partnership

Chapter XXXIV

NATURE OF GENERAL PARTNERSHIP

THE TWO THEORIES OF PARTNERSHIP

The Aggregate Theory. The development of partnership law has been affected by two conflicting theories as to the nature of a partnership. Under the aggregate theory of partnership at common law the firm had no separate legal personality: it was but the aggregate of the individual partners. It could not sue or be sued in the firm name, possess a distinctive seal, or hold the title to real estate. The common law courts, conceiving that artificial legal personality could be conferred only by sovereign grant, refused to recognize as an entity a relation created by private contract.

The Entity Theory. The entity theory of a partnership, on the other hand, conforms with the idea of a business man who thinks in terms of what "the firm owes me" and what "I owe the firm." This theory was operative in developing the characteristics of those associations which flourished in the Italian trade centers in the Middle Ages. In England, under the influence of Mediterranean trade, rules and customs pertaining to partnership developed as a constituent part of the law merchant. When the administration of the law merchant was taken over by the common law there followed confusion resulting from the application to the same facts of two partially inconsistent theories. In 1890 the English law was codified by the English Partnership Act.

The Uniform Partnership Act. In the United States the need for uniform commercial laws led to the drafting of the Uniform Partnership Act by the National Conference of Commissioners on Uniform State Laws, which recom-

mended "that the act be drawn on the aggregate or common law theory, with the modification that the partners be treated as owners of partnership property holding by a special tenancy which should be called tenancy in partnership." The Act was first adopted in New York (1917) and by 1940 had been adopted, with some variations, by twenty states.

ESSENTIAL ELEMENTS OF A PARTNERSHIP

The Act defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." This means:

Contract. There must be a contract of partnership. No particular form is required, but written Articles of Partnership are customarily executed. A partnership may and often does exist in the absence of any express agreement, written or verbal, being implied from the actions of the parties.

Capacity to Become Partners. Capacity to enter into the partnership relation is coextensive with the capacity to contract.

1. **Infant.** An infant can become a partner. He can act as an agent and make binding contracts on behalf of the firm. His own contract of partnership, however, is voidable. He may disaffirm it and recover his capital contribution, with the qualification that he may not withdraw contributions to capital until firm creditors are satisfied in full, his share in firm property being subject to the claims of firm creditors. Even if the firm is insolvent, he may avoid personal liability for firm debts, obligations that he himself may have created.

2. **Married Woman.** The common law denied to a married woman the capacity to become a partner, although it subjected her capital investment in the business to the claims of creditors. Today in most states she has the capacity to become a partner, although in some she is denied the privilege of going into partnership with her husband.

3. **A Partnership.** Two or more partnerships may combine with each other or with a natural person or persons to form a distinct partnership. Thus, if A and B are the members of one firm and C and D the members of another, the two firms may unite to form the partnership X. Profits will be divided in accordance with the agreement between the two firms, and then distributed by each firm to its members. On dissolution a similar division and distribution of assets will be made. But A, B, C, and D will each be individually liable to the creditors of firm X.

4. **A Corporation.** For reasons of public policy a corporation cannot become a partner unless its charter expressly confers up-

on it such authorization. That is to say that as to a particular corporation the contract may or may not be *ultra vires* (beyond the charter powers). To determine the question, the charter must be examined.

Partners Have Equal Rights of Management. An agent is subject to instructions from his principal. A partner, however, is not merely an agent for his copartners; he is also a principal and, as such, has an equal voice with his copartners in the conduct of the business. Although this directional right may be limited or relinquished by agreement (and although a majority decision as to ordinary matters connected with firm business is binding), its existence enables one to distinguish a partner from a mere agent.

Partners Share Profits as Co-Owners of the Business. Co-ownership of property (real or personal) does not of itself establish the existence of a partnership, nor does the mere sharing of gross returns: e.g., as between the lessee of a theatre and the performers, or as between the owners of connecting bus lines each paying his own expenses.

It is not merely the sharing of profits, but the sharing of them *as a co-owner* of the business that makes one a partner. The decisive test is this: Does the recipient of a share of the profits have an equal voice *as proprietor* in the conduct and control of the business? Does he own a share of the profits *as proprietor* of the business producing them? Thus, if one takes a share of the profits as payment of a debt, as wages, as interest on a loan, or as the consideration for the sale of property, he is not a partner.

Community of interest in losses is essential to the partnership relation, and while an agreement to share losses does not of itself establish the existence of a partnership, the absence of such an agreement is strong (though not conclusive) evidence that no partnership exists. (Moreover, a partner may take an indemnification agreement from his copartners. Such agreement would be operative only as between the contracting parties. Firm creditors would not be bound by any provision whereby one of the partners is to be saved harmless from losses, but could enforce to its full

extent the individual liability of such a partner for the debts of the firm.)

Business for Profit. An unincorporated association is not a partnership unless it was formed for the purpose of making profits directly as a result of the business to be carried on. An association may own property and even engage in business transactions and yet not be a partnership. Examples are: trade associations, patriotic, civic, charitable, or religious societies, benevolent and fraternal orders.

KINDS OF PARTNERS

Ostensible Partner: active and known as a partner.

Active Partner: may or may not be ostensible as well.

Secret Partner: active but not known or held out as a partner.

Dormant Partner: inactive and not known or held out as a partner.

Silent Partner: inactive (but may be known to be a partner).

Partners falling in any of these five classes are all individually liable for firm obligations in the same unlimited degree.

Nominal Partner (Partner by Estoppel): not a true partner in any sense, not being a party to the partnership agreement. However, he holds himself out as a partner, or permits others to make such representation by the use of his name or otherwise, and is therefore liable as if he were a partner to third persons who have given credit to the actual or supposed firm in reliance on the truth of such representation. Thus if A, having no interest in the business or profits of the partnership B and C, permits his name to be used as part of the firm name and acquiesces in representations that he (A) is a member of the firm, A is liable as a partner to third persons who have been induced to extend credit to the firm on the strength of such representations. It will be perceived that A's liability here is grounded on estoppel; hence the term partner by estoppel would seem preferable to nominal partner as more accurately indicating the noncontractual nature of the liability.

Subpartner: one who, not being a member of the partnership, contracts with one of the partners in reference to participation in the interest of such partner in the firm business and profits. Consent of the other partners is not requisite to validate such an agreement, because the subpartner is not a member of the part-

nership, has no voice in its affairs, ordinarily has no right to demand an accounting from it, and is not (by the majority rule) liable to its creditors. Subpartnership agreements do not in any wise affect the composition, existence, or operations of the firm.

Limited or Special Partner: risks only his agreed investment in the business. To limit his liability in this manner he must comply with governing state statutes, under which alone limited partnerships can be formed. He must carefully refrain from taking an active part in the management of the business; otherwise he will be held to the liability of a general partner.

CHAPTER XXXV

PARTNERSHIP PROPERTY AND PROPERTY RIGHTS OF A PARTNER

PARTNERSHIP PROPERTY AND PARTNERSHIP CAPITAL

Partnership property is variable: partnership capital is constant. Partnership property includes not only the original capital contributions of the partners, but all property subsequently acquired on account of the firm or with firm funds. The value of partnership property may vary from day to day with changes in the market value of the firm assets.

Partnership capital, on the other hand, represents the aggregate of the individual contributions made by the partners. Such contributions may be in cash or in property of any kind, the value of which has been fixed by agreement.

It is not unusual for a person to be accepted as an equal partner although he makes no capital contribution to the firm. His skill, experience, or following may be such as to entitle him to equal status in regard to control and profit sharing with those who contributed cash or property. On liquidation, however, his distributive share will not include any portion of the capital.

Loans or advances made by partners to the firm are not capital. Nor are undivided profits, unless otherwise agreed. Capital contributions are returnable only on dissolution, but loans are payable at maturity and accumulated profits may be withdrawn at any time by consent of a majority. Partnership capital, accordingly, remains unchanged at the amount fixed by agreement of the partners, and it is not affected by fluctuations in the value of partnership property or assets. A partner who owns, say, a building or a vessel, may agree to permit its *use* by the partnership for a fixed term. Here the partner contributes use but not title to the partnership

stock. The building or vessel does not become partnership property.

Personal Property. The acquisition and transfer of title to personal property may be effected in the real names of the partners or in the fictitious firm name where the latter is used to conduct business.

Real Property. At common law the title to real property could be vested only in a natural person or in an artificial legal person. Hence, real estate could not be held or conveyed in the name of the firm, which, unlike a corporation, was regarded as a mere aggregate of individuals having no separate entity or legal personality apart from that of the partners.

The Uniform Partnership Act has modified the common law rule and, following the entity theory, declares that real property may be acquired, held, and conveyed in the firm name. Thus, a deed to the firm, naming it as grantee by its assumed name, passes the grantor's entire estate, even though words of inheritance are not used.

The Firm Name. A firm name may designate the actual partners: e.g., "Johnson Bros.," "S. White & Sons"; or it may be assumed or fictitious: e.g., "The City Garage Co.," "Frank Black & Co." (there being no Frank Black in the concern). Some states prohibit the use of persons' names as part of the firm name unless the persons named are partners. Where an assumed name is used some states require that a certificate be filed setting forth the assumed name as well as the true names of the partners conducting the business. The failure to comply with registration requirements may involve not merely penal consequences but inability to sue on contracts made in the (assumed) firm name. The use of "& Co." raises a presumption that those trading under such designation are partners. Some states prohibit the use of "& Co." unless it designates a partner.

A firm name is partnership property and the right to its use may be sold or assigned, unless:

1. The name of a partner forms part of the firm name, or

2. The firm name is associated with the personal skill or professional qualifications of those carrying on the business.

Statutes sometimes permit the transfer of partnership names of the kind mentioned in 1 and 2 to successors or assignees. Such legislation is merely permissive and does not indicate that such names can be transferred unless all the partners consent thereto.

Good Will. Lord Eldon's terse definition of good will is easy to remember: "Nothing more than the probability that the old customers will resort to the old place." It is a partnership asset which must be sold and accounted for on dissolution by those who liquidate the business. Elements to be considered in the valuation of good will are:

1. Continuity of name
2. Continuity of place
3. Continuity of organization (where the business structure is intricate).

PROPERTY RIGHTS OF A PARTNER

In Specific Partnership Property. The partners are co-owners of specific partnership property. The incidents of this tenancy in partnership are uniquely characteristic of the partnership relation, and differ from the property rights flowing from other forms of co-ownership such as tenancy in common or joint tenancy. Unless otherwise agreed, a partner has no right to possess any specific item of the partnership stock except for partnership purposes. Nor can he assign his right in specific partnership property unless all the partners unite in assigning their rights therein. For example, A and B are partners in a printing establishment which owns and operates twenty identical presses. A is personally indebted to C and, without B's consent, A delivers to C five of the presses in satisfaction of the debt, C acting in good faith and believing the presses to be A's individual

property. The firm can recover possession of the presses from C. If C now sues A and obtains a personal judgment for the amount of A's debt, C cannot have any of the specific partnership property sold on execution to satisfy his judgment. Only A's beneficial interest can be sold. The nature of this interest is explained below (*Partner's Interest*). When partnership property is attached for a partnership debt, the partners cannot (under the Uniform Partnership Act) claim any right under the homestead or exemption laws. Some few states, however, extend the exemption privilege to partnership property.

On the death of a partner his right in specific partnership property vests in the surviving partners, not in the legal representative of the deceased partner (except when he was the last surviving partner). That is to say, the surviving partners have the right to wind up the business, and the executor of a deceased partner cannot insist on participating in the winding up process.

In Specific Partnership Real Estate. The English courts came to treat land as personal property for all purposes (so far as consistent with the Statute of Frauds and the rules of conveyancing). Accordingly, the personal representative of a deceased partner, and not his heir, succeeded to such real estate. This doctrine of *"out and out conversion"* was not generally followed in the United States. While treating partnership land as personalty as regards the firm business (including the settlement of firm affairs) many American courts refused to carry the fiction of an equitable conversion further, adopting the theory of *sub modo* conversion. That is to say, if any real estate remained after firm affairs had been settled and was no longer required for firm purposes, it resumed its character as land and so descended as real estate according to the applicable laws of inheritance. The partners could, however, effect an "out and out conversion" by express or implied agreement. It has been held that the Uniform Partnership Act adopted the "out and out conversion" doctrine, abolishing dower and curtesy with respect to specific partnership real estate.

Partner's Interest. A partner's beneficial interest in the partnership consists of:

1. His right to an equal share of the profits as they accrue. In the absence of other agreement profits are shared equally, and not in proportion to capital contributions, and losses are shared in the same ratio as profits.

2. His right ultimately (on the winding up of the business and after the discharge of all liabilities to outside creditors, and to partners in respect of loans, and the return of capital contributions) to receive in cash his share of what remains of the partnership property. The value of his share usually cannot be accurately determined before the business has been liquidated.

A partner may assign his interest (for example, as collateral security for a loan) without in any way relinquishing his status or affecting his duties in regard to the conduct of the business. Under such circumstances there would seem to be no good reason why the assignment should of itself work a dissolution of the partnership. Nevertheless, under the common law the mere assignment of a partner's interest dissolved the firm. The Uniform Partnership Act changes this rule. It provides that the mere assignment by a partner of his interest does not dissolve the firm. The assignee, however, during the continuance of the partnership, has only one right: to receive whatever share of the profits the assignor-partner would have been entitled to receive under the partnership agreement. "In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners."

Partner's Interest Subject to Charging Order. The procedure evolved at common law for subjecting the interest of a partner to the claims of his separate creditors was both cumbersome and uncertain. The Uniform Partnership Act provides a new remedy for the separate judgment creditor. He may obtain a charging order, providing that the interest of the debtor partner may be charged "with the amount of such judgment debt with interest thereon." The court may

appoint a receiver of the debtor partner's share of the profits "and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts, and inquiries which the debtor partner might have made, or which the circumstances of the case may require." The assignee or purchaser of a partner's interest is entitled to a decree of dissolution upon application "at any time" if the partnership was a partnership at will, otherwise "after the termination of the specified term or particular undertaking."

Chapter XXXVI

RELATIONS OF PARTNERS TO ONE ANOTHER

THE PARTNERSHIP AGREEMENT GOVERNS

Intra-partnership matters are governed by the Articles of Partnership. The division of profits and apportionment of losses, compensation for services, custody of books of account, indemnity and contribution, management, interest on capital investment—these are but a few of the matters which the parties may by agreement effectively regulate as to themselves, though the provisions will not in many cases be effective as to third persons dealing with the firm. As to intra-partnership matters not specifically dealt with by the Articles of Partnership, the following rules and principles will control.

BOOKS AND INFORMATION

Each partner has an equal right to inspect and make extracts from the partnership books, which must be kept at the partnership place of business so that they may be accessible to the partners at all times.

COMPENSATION FOR SERVICES

A partner is not entitled to any compensation (other than his share of the profits) for his services, although they may outweigh those rendered by his copartners, except that under the Uniform Partnership Act "a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs."

GOOD FAITH

Partnership is a fiduciary relation. Accordingly, a partner must account to the firm for secret profits made by him in

conducting the partnership business or by diverting his time or skill to a competing business. Similarly, he may not appropriate to himself any private advantage resulting from the business of the firm or secure for himself that which he should obtain (if at all) for the firm. Thus, he may not for his own benefit, and without the knowledge and consent of his copartners, take a renewal of a partnership lease, even though the renewal lease embraces additional space and is not to commence until the partnership expires. He may not use for himself information belonging to the firm or useful to it for any purpose within the scope of its business. He may not buy goods and resell them to the firm at a (secret) profit.

If he engages in a noncompetitive business for his own benefit, his copartners are not entitled to share in the profits of such business (since the profits are not made in violation of his fiduciary duty) even though his action is inconsistent with an express covenant of the partnership agreement. But his copartners would seem clearly to be entitled to whatever other remedy by way of damages, injunction, or dissolution may be available.

CONTRIBUTION AND INDEMNITY

A partner: (1) must contribute towards losses (capital or otherwise) sustained by the partnership, in accordance with his share of the profit, (2) is entitled to indemnity by the firm as to payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business (or to preserve its business or property), but not in respect to a loss caused by his own personal misconduct, negligence, or breach of the partnership agreement. Negligence, however, implies a degree of culpability beyond that involved in mere errors of judgment.

PROFITS AND LOSSES

1. The Articles of Partnership may fix: (a) to what extent a partner is to share in profits, and (b) to what extent he must contribute to losses.

Any limitation or exemption a partner may enjoy under (b) is not effective as to creditors who may enforce his individual liability for firm debts to the full extent.

2. The Articles of Partnership may fix a partner's share of the profits, but be silent as to the extent of his contribution to losses. In that event he must bear a part of the loss proportionate to his share of the profit.

3. The Articles of Partnership may be silent both as to profit sharing and loss apportionment. In that event profits and losses are shared equally, and *not* in the ratio of capital contributions.

Capital represents a debt of the firm to the contributing partner. If, on dissolution, assets are insufficient to repay capital investments, the deficit is a capital loss which requires contribution like any other loss.

If an insolvent partner's share of the firm loss exceeds the amount due him on account of loans and capital investment in the firm, the excess must be shared by the solvent partners in the same ratio as that in which they share profits. Thus if A, B, and C share profits in the proportion of 3:4:5, and B (insolvent) should contribute $8,000, A must assume $3,000 and C $5,000 of this loss.

INTEREST ON CAPITAL INVESTMENT AND ADVANCES

Unless otherwise agreed, a partner is entitled to interest on his capital investment, or part thereof only from the date on which it was to be repaid to him. Amounts paid into the firm in excess of a partner's agreed capital contribution constitute loans or advances which draw interest from the date on which they are made. (The rule is not changed by the fact that loans or advances may, as a matter of bookkeeping, be credited to the partner's capital account. Accumulated profits do not draw interest, as they are not regarded as loans or advances merely because they are left with the firm. However, an agreement to treat undivided profits as loans to the firm may be implied from custom, usage, or other circumstances.)

MANAGEMENT

The "property" right of each partner to an equal voice in the conduct of the business is, it will be remembered, one of the distinctive characteristics of the partnership relation. Nor is this right dependent on the size of a partner's capital contribution. But the partners may, of course, select a managing partner or make such other division of work and responsibility as expedience dictates.

Differences arising in the ordinary course of business may be resolved in accordance with the will of a majority of the partners. But the majority cannot, in the face of minority opposition, change the nature of the business, or engage in a new line of business; change the capital structure by increasing or diminishing a partner's capital contributions as originally fixed; or admit new members to the firm. Any proposed act which deviates from or contravenes the terms of any agreement between the partners cannot be rightfully performed without the consent of all. Likewise, unanimous consent is required (except as regards partners who have abandoned the business) to: make an assignment of the partnership property for the benefit of creditors, confess a judgment, dispose of the good will of the business, submit a partnership claim or liability to arbitration or reference, or do any other act which would make it impossible to carry on the ordinary business of a partnership.

Where the firm consists of only two partners, dissolution is the only remedy for protracted disagreements, unless the articles of partnership provide some method for the settlement of disputes.

RIGHT TO AN ACCOUNTING

An action in equity for an accounting is ordinarily not maintainable except as an incident to dissolution where a final adjustment of all partnership affairs is to be effected by a decree of the court, the partners having been unable to arrive at an amicable settlement. No accounting will lie to settle petty differences or disputes between partners. It is not the office of a court of equity "to enter into a con-

sideration of mere partnership squabbles" or "on every occasion to take the management of every playhouse and brewhouse."

While a partner, having equal access with his partners to the partnership books, is not ordinarily entitled to a formal account, except on dissolution, special and unusual situations may arise in which he will have the right to an accounting in equity without bringing about a dissolution. These exceptional cases are:

1. Where a partner is wrongfully excluded from the firm business and the term of partnership has not expired.

2. Where by agreement a formal account was to be rendered at a definite date.

3. Where a partner has sought to withhold secret profit derived from a transaction connected with the formation, conduct, or liquidation of the firm or any use by him of its property.

4. Where circumstances render it just and reasonable (e.g., when one partner has been traveling for a long period of time on partnership business, the other partners being in possession of the partnership books; where insolvency is imminent and the partners are too numerous to be made parties to the action, in which case a limited account may result in justice to them all; or where there has been an execution levied on the interest of one of the partners).

ACTIONS AT LAW BETWEEN PARTNERS

Prior to the final settlement of a partnership business, one partner cannot maintain against his copartner an action at law founded upon the partnership agreement. There is no rule which prohibits lawsuits between the individual partners, but it is ordinarily impossible to determine the indebtedness of one partner to another until liquidation of the business has taken place and partnership accounts have been settled. A court of law lacks the machinery appropriate to such determination (which may involve numerous claims and counterclaims extending over a long period of time and

may necessitate complicated reckoning). Such accounting can be had only in equity (ordinarily as an incident of dissolution).

A partner may, of course, sue his copartner at law on a claim not connected with the partnership business or even on a claim isolated by agreement from the general partnership accounts, as when a bill or note is given therefor.

Chapter XXXVII

RELATIONS OF PARTNERS TO PERSONS DEALING WITH THE PARTNERSHIP

ACTUAL AND APPARENT AUTHORITY

In dealing with third persons on behalf of the firm each partner acts as an agent for the partnership. His power to bind the firm must, therefore, be either actual or apparent. Actual authority derives solely from the agreement of the partners. If the partnership agreement is silent as to the partners' authority, each partner has the implied authority to do all things necessary for the conduct of the ordinary business of the firm. This implied authority is just as real, just as actual, as if specifically conferred by express terms of the partnership agreement.

Apparent authority, on the other hand, is based on the principle of estoppel. Third persons dealing with a partner may rightly assume that he has power to bind the firm in an ordinary business transaction. Thus, A and B, partners in a trading concern, agree that A shall have sole and exclusive authority to buy goods. B, in violation of the agreement, but apparently carrying on in the usual way the business of the firm, gives X a purchase order, X having no notice of B's lack of (actual) authority. The purchase contract binds the firm, A as well as B. B had no actual authority in the premises, but his apparent authority to carry on the firm's business in the usual way cannot be circumscribed by agreement between the partners.

A third person, dealing with a partner who purports to have authority to bind the firm in a particular transaction, must ask himself: Is it necessary for me to investigate the extent of this man's actual authority? Must I read the partnership agreement? Or am I safe in assuming that if I contract with him I shall secure a valid obligation of the partnership which he represents?

It follows that whenever a third person has knowledge or

notice of some limitation on the actual authority of a partner he will not be able to hold the firm liable if the partner with whom he deals transcends the limits of his actual power. Thus, in the example given above, if X knew that B lacked actual authority to buy for the firm, or if X had knowledge of such other facts as in the circumstances showed bad faith, the purchase contract would not bind the partnership.

PARTNER'S APPARENT AUTHORITY IN GENERAL

A partner has apparent authority to do any act that falls within the scope of ordinary business. Thus, in a trading concern, engaged primarily in the purchase and sale of commodities, each partner has apparent authority for a partnership purpose, to borrow money and obligate the firm by signing commercial paper. On the other hand, a partner in a non-trading firm, engaged primarily in the production of commodities or the rendering of professional services, would not ordinarily possess the power referred to. Examples of non-trading firms may be found among architects, attorneys, accountants, auctioneers, physicians, theatre owners, and farmers.

Close questions often arise as to whether or not a specific power falls within the scope of a given business. The following is not intended to be an exhaustive list of specific powers, but to suggest questions which have given rise to considerable litigation.

SPECIFIC POWERS

A Partner Has Implied or Apparent Authority to:

A. Sell partnership personalty held for purposes of sale (e.g., merchandise, negotiable instruments, trade-marks, patent rights, accounts receivable) in the ordinary course of business. The power to sell includes the power to make customary warranties.

A Partner Does Not Have Implied or Apparent Authority to:

A. 1. Sell property not held for sale, such as fixtures, plant, or equipment used in the business.

2. Make a bulk sale of the entire stock, not in the ordinary course of the business.

3. Dispose of the good will of the business.

B. Buy for cash or on credit goods that may reasonably be considered as necessary in relation to the firm's business or apparently within the usual method of carrying it on. (The partnership cannot escape liability for such purchases, even though the partner who purported to act on behalf of the firm converted the goods to his own use.)	
C. **Borrow money,** if the firm is a trading partnership. This involves the power to mortgage or to pledge the firm's personal property as security for present advances and antecedent partnership debts as well. Also, the power to execute negotiable paper binding the firm. (See F below.)	C. Borrow money, if the firm is a non-trading partnership, or pledge or mortgage firm property to secure firm debts.
D. **Pay partnership debts** out of partnership funds or by a transfer of partnership assets, even if they are not held for sale (unless they are necessary to the continued conduct of the business).	D. 1. Pay his individual debts with firm funds or assets. 2. Assign the partnership property in trust for creditors.
E. 1. **Collect or compromise** debts due the firm. 2. Give a satisfaction of judgment.	E. 1. Confess a judgment. 2. Submit a partnership claim to arbitration or reference.
F. **Execute commercial paper** in the firm name for partnership purposes if the firm is a trading partnership.	F. 1. Bind a non-trading partnership by making, accepting, or indorsing negotiable paper, even though it is executed in the firm name and for a proper partnership purpose. 2. Sign accommodation paper in the firm name (whether in a trading or non-trading partnership) for the benefit of a third person. Such generosity would be at the expense of the other nonsignatory partners.

G. Make contracts of guaranty, suretyship, or indemnity which are for the benefit of the firm or within the scope of its business.

H. Employ necessary servants or agents, and engage legal counsel.

I. Conduct litigation by or against the partnership.

J. Partners may ratify the unauthorized act of a copartner.

G. Execute on behalf of the firm a contract of guaranty or suretyship for his individual benefit or for the benefit of third persons.

K. At common law bind his partners by a sealed instrument executed in the partnership name or in the names of the partners, as authority to execute such instrument could be conferred only by an instrument under seal. (But one partner can execute a valid release under seal, the reason being that at common law if A, B, and C held a joint claim against X, A's release discharged the claim of B and C.)

POWER TO SELL OR MORTGAGE REAL PROPERTY

It is said that the Uniform Partnership Act "does away with the existing uncertainty surrounding the subject of the conveyance of real property belonging to a partnership." The following situations are contemplated by the Act:

A. Title in Firm Name: Conveyance in Firm Name. Assume that real property is owned by, and in the name of, the Metro Co., a partnership composed of A, B, and C. If A delivers to X a deed to the property executed in the name of the Metro Co. as grantor, the partnership may recover such property unless:

1. A had actual or apparent authority to convey: e.g., if the Metro Co. was engaged in the business of buying and selling real estate, or

2. X had reconveyed to Y, for value and without notice of A's want of authority.

B. Title in Firm Name: Conveyance in Partner's Name. If, in the preceding example, A, having actual or apparent authority to convey, delivered to X a deed naming A as grantor, then X

acquires an equitable interest and can compel the partnership to transfer the legal title to him.

C. **Title in Names of Some of the Partners: Property Purchased with Firm Funds.** Assume that A uses firm funds to pay for a parcel of real estate and takes a conveyance in his own name. If A conveys to X, the Metro Co., (whose interest the record does not disclose) may recover the property unless:

1. A had actual or apparent authority to convey, or

2. X or his assignee is a bona fide purchaser for value without notice.

D. **Title Held in Trust for the Partnership.** Assume that the record title to real estate is in A and B (some or all of the partners) in trust for the Metro Co. If A, having actual or apparent authority, conveys to X in his (A's) own name or in the firm name, X acquires an equitable interest. If the property were held by some third person (T) in trust for the Metro Co., A similarly would have the power to convey to X an equitable interest therein, assuming always that A had actual or apparent authority to agree to and deliver the deed to X, which would depend upon the nature of the partnership business as explained above.

E. **Title in Names of All Partners.** If the title is held in the name of A, B, and C, a conveyance to X, executed by A, B, and C, passes to X all their rights to the property.

NOTICE TO A PARTNER

In the absence of fraud, notice to one partner is notice to all as to any matter relating to the partnership business, and the knowledge of a partner is imputed to the firm claiming through his act. The failure of a partner to communicate such notice or knowledge to his copartners does not make its effect any the less binding upon them.

ADMISSIONS OF A PARTNER

Admissions of A as to the existence of the partnership A, B, and C are not competent as against B and C to prove that he and they are partners. But if the existence of the partnership has been otherwise proved by competent evidence, the declarations and admissions of A concerning partnership matters in the course of and material to firm business and within the scope of his authority are admissible against the firm.

LIABILITY OF PARTNERS

Contracts: Joint Liability. Under the Act the partners are jointly liable on partnership contracts. This means

that the law treats the contract as *one single* promise—not as separate promises made by each of the partners. Consequently:

1. Unless there has been severance by operation of law, each partner should be named as a defendant in a contract action against the firm.

2. If judgment in such action is rendered against one or more of the partners, it operates as a merger and discharges the joint duty of the other partners.

3. The judgment creditor of the partnership has the option to levy on firm assets or separate property of the partners (but in some states separate property cannot be levied on unless the partnership property is insufficient to satisfy the judgment).

4. A release given to one of the partners releases all.

5. Under the common law rule the surviving partners, and not the estate of a deceased partner, were liable on a joint partnership contract. (Many states have enacted statutes providing for a remedy against the estate of the deceased partner.)

In some states partners are jointly and severally liable on contract obligations.

Torts: Joint and Several Liability. A partner who commits a tort while acting with the authority of the partners or in the ordinary course of firm business, or a partner who commits a breach of trust by misappropriating property of a third person (received by him within the scope of his apparent authority or by the firm in the course of its business), imposes a joint and several liability upon the partners. This means:

1. The partners may be sued jointly in one action, or any or each may be sued separately.

2. Release of one partner would, under the common law rule, release all; but many states have modified the rule by statute.

Contracts: Liability May Be Several as Well as Joint. The partners may make themselves severally liable on a partnership contract. Thus, if A and B are partners trading as the Metro Co., a note may be executed in the name of the Metro Co. and delivered to X. This note represents a joint obligation of the partners. If now A and B each personally endorse the note, it becomes the several obligation of A and B as well.

CHAPTER XXXVIII

DISSOLUTION

DISSOLUTION DEFINED

Dissolution is that point in time when any partner ceases to be associated in carrying on the business. Ordinarily it results from a partner's retirement. But dissolution just as truly occurs when a new member is taken into the firm without the liquidation of the affairs of the existing partnership. For any change in membership dissolves a partnership and creates a new partnership.

Termination. Dissolution signifies that the actual conduct together of the ordinary business of the partnership is at an end. Thus, when a partner retires the firm is dissolved. Subsequent activities should be directed toward winding up the business. When the business has been completely wound up and partnership affairs have been finally settled, then (but not until then) the partnership is terminated. The time order is: Dissolution, Winding up, and Termination.

CAUSES OF DISSOLUTION

Expiration of the Agreed Term. Where the partnership agreement fixes the period of the firm's duration, dissolution takes place at the expiration of such period. If thereafter the partners continue the business without making a new agreement, the firm becomes a partnership at will. Nevertheless, the rights and duties of the partners remain the same as they were at the termination of the period fixed by the original agreement, so far as consistent with a partnership at will.

Withdrawal of a Partner. The voluntary or involuntary withdrawal of a partner dissolves the firm. Such withdrawal may be caused by:

1. **Rightful Retirement:** the voluntary retirement of a partner in a partnership at will. Here each partner has both the power and the right to terminate the partnership relation at any time, even though his copartner wishes to continue the business.

2. **Wrongful Retirement:** the voluntary retirement of a partner before the time fixed for the duration of the partnership has expired. A partner is both principal and agent. Like an agent, he has the power to sever the fiduciary relationship at any time. Of course, the exercise of such power may be wrongful. It may be in violation of the partnership agreement. The retiring partner will then be liable in damages to his copartners. But a court of equity will not decree that he continue as a partner for the unexpired term of the agreement. The personal nature of the partnership relation precludes the exercise of equitable jurisdiction.

3. **Death of Partner.** Like other contracts which involve personal, nondelegable rights and duties, the contract of partnership is terminated by the death of a partner. The survivors have no authority to continue the business except so far as is necessary to wind it up. If they do, they are within the general rule that if the business is continued (after death or retirement of a partner, A) without settlement of accounts, the continuing partner or partners must account (at the election of A or his estate) either for profits attributable to A's interest remaining in the business, or for interest thereon. If the partnership agreement provides for the continuation of the partnership by the admission of the legal representatives or assigns of the deceased in his stead, and the latter elect to avail themselves of such opportunity, a new partnership is created of which they are members. Alternatively, the agreement may provide that, on the death of a partner, his capital or interest may remain in the business which is to be continued. Under such provision the estate of the deceased is not liable for obligations incurred after dissolution except to the extent of his capital or interest permitted to remain in the business, and his legal representatives are not entitled to become partners. Another method of preventing the forced liquidation of assets and winding up which the death of a partner would otherwise entail is to provide in the partnership agreement that the surviving partners shall have the option of purchasing the interest of the deceased partner at a price to be fixed by appraisal or otherwise in accordance with whatever method of valuation may be agreed upon.

4. **Bankruptcy of Partner.** The bankruptcy of a partner dissolves the partnership. The trustee in bankruptcy takes title to and assumes control of the bankrupt partner's assets, including his interest in the partnership, thus making it impossible to carry on the business. Similarly, dissolution results where a partner makes a general assignment of his assets for the benefit of creditors. The Uniform Partnership Act defines "Bankrupt" to include insolvent under any state insolvent act as well as bankrupt under the Federal Bankruptcy Act.

5. **Expulsion of Partner.** Apart from express agreement, partners have no power to expel a copartner. Where a partner is guilty of serious misconduct, the only remedy ordinarily available to copartners is to apply to the court for dissolution. But the partnership agreement may expressly confer the power to expel a partner under specified conditions. When this power is exer-

cised in good faith, it causes dissolution (without violation of the partnership agreement) although no suit has been instituted to that end.

Admission of an Incoming Partner dissolves the existing firm although the business is continued without liquidation of the debts. Dissolution is caused by any change of personnel as explained above.

Agreement of All Partners. All the partners may, by mutual consent rescind the partnership agreement, thereby dissolving the firm. Where partners divide the entire partnership assets among themselves, the severance of their interests evinces an intention to effect dissolution. The consent of a partner who has assigned his interest is not required for such dissolution, nor is that of one whose interest has been charged for his separate debts.

Supervening Illegality dissolves the partnership. Thus, firms in the liquor business were dissolved by the passage of the National Prohibition Act. Declaration of war between nations of which the partners are respectively citizens dissolves the firm, as the partners become, in contemplation of law, enemies.

Bankruptcy of the Partnership dissolves the firm.

Court Decree of Dissolution based on any one of the following grounds:

1. **Total Incapacity** of a partner, resulting from insanity or other causes.

2. **Conduct** of a partner tending to affect prejudicially the carrying on of the business, or such conduct therein that it is not reasonably practicable to carry it on with him. Temporary grievances, discourtesies, disagreements, mistakes of judgment will not suffice as the basis for a decree of dissolution. Any one of the following will constitute an adequate ground: wilful and persistent breaches of the partnership agreement, commission of fraud, misappropriation of firm funds, inveterate drunkenness, unwarrantable negligence.

3. **No Possibility of Profit.** By definition, partnership is a relation established for the purpose of making profit. If the business is in a hopeless state and further operations can be carried on only at a loss, dissolution will be decreed.

4. **Other Circumstances** frustrating the attainment of the end for which the partnership was created would similarly justify the court in dissolving the firm on the application of or for one or more of the partners.

5. Application Made by Purchaser of Partner's Interest (See p. 245.)

DISSOLUTION: EFFECT ON PARTNERS

New Business Must Not Be Transacted.

1. The Common Law Rule. After dissolution the partnership must be wound up, and only transactions designed to terminate rather than to carry on the business are within the scope of the partner's actual authority. Unfinished business may be completed, but a partner who continues to transact new business and create new obligations on behalf of the firm assumes sole liability. If losses result, he alone must bear them. Thus, if A, B, C, and D are partners, assume that A, B, and C are active partners in New York and that D is an entirely inactive partner in San Francisco. D's act, death, or bankruptcy may automatically dissolve the firm. If A makes a contract on behalf of the partnership after such act, death, or bankruptcy of D, it is A's personal contract, not that of the partnership. If the contract results in a loss A cannot compel B, C, and D's estate to share it. This is true even though A, B, and C had no notice or knowledge of the dissolution at the time A contracted.

2. Uniform Partnership Act Rule. The Uniform Partnership Act changes the common law agency rule and, in the illustration given in the preceding paragraph, imposes contractual liability on each partner if at the time A made the contract A had no knowledge or notice of dissolution by D's act or of the death or bankruptcy of D. The Act, however, does not impose any liability on B, C, and D if, at the time A made the contract, dissolution had occurred because of some statutory enactment making continuance of the business illegal.

The Partnership Business Must Be Wound Up. Every partner, except one who has wrongfully caused a dissolution, has the right to participate in winding up the affairs of the business. The method of liquidation to be followed may be determined by a majority of the partners. Unless the partners agree on a distribution in kind, all assets ex-

cept real estate must be converted into cash. Under the Uniform Partnership Act real estate, being treated the same as personalty, must also be turned into cash.

Where dissolution is caused by the death of one of the partners, the title to partnership property passes to the surviving partners. Theirs is the duty to wind up the business, and the legal representative of a deceased partner has no right to participate in the liquidation process. If all the partners are dead, the legal representative of the last surviving partner, not bankrupt, has the right to wind up the partnership affairs.

DISSOLUTION: EFFECT ON THIRD PARTIES

Partners Liable for Existing Debts. While dissolution terminates a partner's actual authority to create new obligations binding on the firm, it does not release the partners from their individual liability for existing firm debts. Thus, if A, B, and C are partners and A retires, all three (A as well as B and C) continue to be personally liable for firm debts existing at the time of A's retirement. Similarly, if A dies, his individual estate is available to firm creditors, subject, however, to the claims of A's personal creditors, as explained on p. 267. Even an agreement among A, B, and C whereby B and C promise to assume the firm debts does not release A, unless the creditors assent to such substitution of debtors, either by express agreement (novation), or by agreement inferable from course of dealing. However, according to the weight of authority and under the Uniform Partnership Act, where A retires and B and C assume payment of existing liabilities, A becomes (as regards them) a surety. Therefore, even though there has been no novation, A is released as to any creditor who, knowing of the agreement, agrees with B and C upon a material change in the nature of such liabilities or upon extension of the time of payment.

Notice of Dissolution Necessary.

1. Actual Notice to Creditors. Where A, B, and C are active and ostensible partners, A's retirement terminates

the actual authority of A, B, or C to impose new obligations on the partnership, except such as may be necessary to wind up the business. But each partner has been held out to certain persons as an agent possessed of continuing power, and, on principles of the law of agency, such persons would be justified in relying on such continuing apparent authority unless proper notice were given that dissolution has in fact occurred. Those who, prior to dissolution, extended credit to the firm, are entitled to personal notice. Hence, assume that X has extended credit to the partnership A, B, and C prior to A's retirement, and has no knowledge of A's retirement, and that no notice thereof has been communicated to X, by mail or otherwise; then, on the ground of estoppel:

(a) If B or C, purporting to act on behalf of the firm, contracts with X (e.g., orders goods), the firm (A, B, and C, jointly) is liable to X.

(b) If A, purporting to act on behalf of the firm, contracts with X, the firm (A, B, and C, jointly) is liable to X. Just as a principal would have to give actual notice to third persons who had been creditors, in order to revoke the authority of an accredited agent with whom they had dealt, so notice of dissolution must be brought home to each person who, prior to dissolution, had extended credit to the partnership. Actual notice means personal notice or a written communication delivered at a person's place of business or residence. Both at common law and under the Uniform Partnership Act actual notice to firm creditors is required where the dissolution was caused by the act or agreement of the partners (e.g., retirement of a partner, as in the example given above).

2. Public or General Notice to Others. Where dissolution is caused by the act or agreement of the partners some form of public notice must be given to a third person who had known of the partnership prior to dissolution although he had not extended credit to it. Even those who had no dealings with the firm but knew of its existence are entitled to public notice of dissolution. Such notice may be given by advertising the fact of dissolution in a newspaper

of general circulation in the place at which the partnership business was regularly carried on.

3. NOTICE WHERE DISSOLUTION IS CAUSED BY OPERATION OF LAW. At common law neither actual notice to persons who had been creditors nor public notice to others was necessary where dissolution was caused by operation of law (e.g., by death of a partner, bankruptcy, court decree, or supervening illegality) as distinguished from those cases in which dissolution was caused by agreement or an act of the parties (e.g., retirement). The common law view was that every person "must take" notice of dissolution caused by operation of law; i.e., he was charged with notice whether such notice had in fact been received by him or not. Under the Uniform Partnership Act, the requirement of notice, in order to avoid liability to third persons by estoppel, has no application where the partnership is dissolved because its business may not lawfully be carried on (supervening illegality) or where the acting partner has become bankrupt. Otherwise than in these two cases, the requirement of notice applies (under the Act) irrespective of the cause of dissolution, and it is specifically provided that the firm is bound by estoppel, notwithstanding lack of authority in the acting partner to wind up firm affairs, unless the foregoing requirement of notice was met.

Although, under the Act, a bankrupt partner may incur liability after dissolution unless notice is given, he can impose no liability on his copartners, since, both at common law and under the statute, third persons who deal directly with the bankrupt partner "must take" notice of his status.

4. DORMANT PARTNER NEED NOT GIVE NOTICE. A dormant partner is both inactive and secret. His connection with the firm not having been known, it cannot in any degree have contributed towards establishing its reputation or credit. Third persons, not having dealt with the firm in reliance upon the membership of a dormant partner, are accordingly not entitled to notice of his withdrawal. The principle of estoppel cannot operate to continue his liability or his authority after dissolution, since prior thereto he was

never known or held out as a partner. He will, of course, be personally liable for firm debts and obligations existing at the time of his retirement.

Changes in Membership. Assume that C is admitted as a new partner into the existing partnership of A and B. Technically, the old firm of A and B is dissolved and a new firm composed of A, B, and C is formed. Unless the new firm assumes existing liabilities, creditors of the old firm will be deprived of the priority which they formerly enjoyed with respect to firm assets: such priority now belongs to creditors of the new firm. Furthermore, in the event of insolvency, creditors of the old firm cannot share in the separate estates of A and B until the individual creditors of A and B have been paid in full. The net result, at common law, was that creditors of the old firm would get nothing.

The Uniform Partnership Act abrogates this unfair rule. It substitutes the principle of equality as between creditors of the old and the new firm. In the example given, C will not be individually liable for the debts of the old firm. His investment, however, constituting a part of the firm assets, will be equally available to both creditors of the old and creditors of the new firm.

Various other changes in personnel effect a technical dissolution, yet justice dictates that the two sets of creditors involved, those of the old and those of the new firm, be treated on an equal basis. A note to the Act provides: "When there is a continuous business carried on first by A, B, and C, and then by A, B, C, and D, or by B or C, or by B and C, by B and D, or by C and D, or by B, C, and D, without any liquidation of the affairs of A, B, C, both justice and business convenience require that all creditors of the business, irrespective of the exact groupings of the owners at the times their respective claims had their origin, should be treated alike, all being given an equal claim on the property embarked in the business."

Similarly, the statute provides that if A, B, and C sell the business to X and if X promises to pay the debts and to con-

tinue the business, the creditors of the dissolved firm of A, B, and C are also creditors of X.

DISTRIBUTION OF ASSETS

Solvent Firm. After dissolution, the business must be wound up. Liquidation ordinarily involves converting all assets into cash. Then a final accounting is made to determine assets and liabilities and to adjust the partners' accounts. Distribution must then be made in accordance with the established rule as to priority, which requires assets to be applied:

First: To payment of all firm creditors other than partners.

Second: To payment of all loans or advances to the firm made by a partner, or liabilities incurred by a partner on behalf of the firm.

Third: To repayment of the capital contributions made by each partner.

Fourth: Any balance constitutes profit and is distributed among the partners equally, or in the ratio fixed by agreement.

Insolvent Firm.

1. Firm Creditors Have Prior Claim to Firm Assets. A court of equity, administering the affairs of an insolvent partnership, applies a principle of distribution known as marshaling assets. This means that the individual creditors of the partners may not compete with creditors of the firm in proving their claims against partnership assets. Or, to put it differently, with respect to partnership assets firm creditors have priority over the individual creditors of each partner.

2. Firm Creditors May Lose Priority Rights. The prior right of firm creditors to be paid out of firm assets is, (as we have seen) derivative—that is, it is worked out through the partner's "lien" or equity that partnership property shall be first applied to the satisfaction of partnership debts. The purpose of the doctrine is to protect each partner by way of exonerating him for firm debts so far as

firm assets will reach. It follows that a partner has the right to waive his equitable lien, and the partners, accordingly, have the power to make any honest disposition of the firm property they desire. Together they may assign or mortgage partnership property to pay or secure the individual debt of one of the partners. Similarly, where A and B are partners, A may sell his interest to B in consideration of B's assumption of the partnership liabilities. The partnership property thus becomes B's individual property in which creditors of the firm have no priority, unless the assignment to B was upon trust to pay the firm creditors out of the assets.

3. FRAUDULENT TRANSFERS. Assume that A and B are partners, and that A sells his interest to B, both A and B knowing that the firm is insolvent. Partnership creditors may attack such transfer as fraudulent.

In states which have adopted the Uniform Fraudulent Conveyances Act such transfer is fraudulent as to firm creditors if the firm was in fact insolvent, irrespective of the knowledge of A and B.

The same considerations apply where all the partners sell the partnership property to a stranger and appropriate the consideration by apportioning it among themselves, instead of dealing with it as partnership funds or assets.

Insolvent Partner.

INDIVIDUAL CREDITORS HAVE PRIOR CLAIM TO INDIVIDUAL ASSETS. When the insolvent estate of a partner is being administered in bankruptcy or in equity, individual creditors are given priority over creditors of the partnership. This is the rule of the common law; it has been followed by the great majority of states, and adopted by the Uniform Partnership Act and the Bankruptcy Act.

Priority of Individual Creditors: Exceptions to Rule.

1. **No Firm Assets.** Where no partnership assets exist, it has been said that the reason for the rule disappears, and firm creditors have been permitted to share the separate estate of an insolvent partner *pari passu* with the individual creditors. Whatever following this exception may have had in the state courts, the Supreme Court has expressly rejected it as being contrary to the

statutory rules of distribution prescribed in bankruptcy administration. The Uniform Partnership Act, Sec. 40, likewise, does not recognize the exception.

2. **Separate Trade Transaction.** Where A and B are partners and A became indebted to the partnership in a separate trade transaction, the firm has been allowed to prove against A's insolvent estate *pari passu* with A's personal creditors. Neither the Uniform Partnership Act nor the Bankruptcy Act makes reference to this exception.

3. **Fraudulent Conversion of Firm Assets.** Where a partner fraudulently converted partnership property to his own use, thereby enriching his personal estate, the partnership has been permitted to compete with separate creditors.

4. **Claim of the United States.** In bankruptcy the United States has priority over private creditors, and as a firm creditor the United States has priority over separate creditors of a partner whose personal estate is being administered.

Part VII: Corporations

Chapter XXXIX

CHARACTERISTICS, ORGANIZATION, AND DISSOLUTION

CHARACTERISTICS

A corporation is a legal entity separate and distinct from its members and existing by permission of sovereign authority, either federal or state. It may sue and be sued in its own name, hold the title to real and personal property, possess and use a corporate seal, and enjoy perpetual duration, unaffected by the death of its members or by the transfer of their interests, which (in business corporations) are represented by shares of stock.

Limited Liability of Stockholders. The liability of a stockholder is limited to his investment as represented by the shares of stock which he owns. Even if one man owns all the stock, he will not be personally liable for debts of the corporation, unless he has conducted business as an individual proprietor totally disregarding the corporate forms.

"Piercing the Veil" of Corporate Entity. The courts will not permit the corporate form to be used as an instrument of fraud or illegality and will "pierce the veil of corporate entity" when justice requires. (A owns all the stock of the X corporation. B authorizes A to contract for the sale of certain property. A contracts to sell it to the X corporation without disclosing to B the facts in regard to stock ownership. B can avoid the contract: the court will disregard the separate entity of the X corporation and treat the case as if A had sold the property to himself.)

KINDS OF CORPORATIONS

With reference to *function* corporations are:

1. *Public* (counties, cities, villages: political subdivisions of the state),

2. *Quasi-public* (R.F.C., T.V.A., drainage districts, school districts, public utilities: railroads, telephone, power and light companies),

3. *Private* (business or non-business corporations—clubs, charitable organizations — not charged with public duties).

With reference to *structure* corporations are:

1. *Stock Corporations* formed for profit, in which the ownership of members is represented by shares of stock, as:

(a) Moneyed Corporations: banks and finance companies,

(b) Business Corporations: manufacturing and trading companies, public utility corporations,

2. *Non-Stock (Membership) Corporations* not formed for direct pecuniary profit and in which no stock is issued, the by-laws prescribing the conditions under which one may become a member. Such corporations may be formed for religious, social, fraternal, or mutual benefit purposes.

ORGANIZATION PROCEDURE

Certificate of Incorporation (Charter). Although corporations may be created by special act of the legislature, today, in most states, general statutes prescribe the steps necessary to their formation. The Stock Corporation law of New York is fairly representative of general statutes authorizing the formation of business corporations for profit. Its requirements may be summarized as follows: a business corporation can be formed by three or more persons, each over twenty-one years of age. Two-thirds of the total number of incorporators must be citizens of the United States, and at least one must be a resident of New York State. The incorporators must prepare a certificate setting forth:

1. The name of the proposed corporation (which must not be the same as one in use or deceptively similar to it, and which must contain some word or abbreviation — e.g., "Inc." — clearly indicating that it is a corporation).

2. Purposes for which it is to be formed (corporations are not permitted to practice law or medicine).

3. Either the amount of the capital stock and the number and par value of the shares, or if the corporation is to issue shares without par value, the number of such shares and a statement as to the amount of capital.

4. If more than one class of stock is to be issued, the preferences, privileges, and voting powers of each class must be exactly designated.

5. Location of its office.

6. Its duration.

7. The number of directors (not less than three) and the names and addresses of the first board of directors and their term of office.

8. The names and addresses of the subscribers to the certificate, and the number of shares of stock which each agrees to take (some states require a statement as to whether the stock is to be paid for in cash or in property).

9. Designation of the secretary of state as agent upon whom legal process may be served in an action against the corporation.

10. If the meetings of the board of directors are to be held only within the state, the certificate (or by-laws) must so provide. A similar provision is necessary to dispense with the requirement that directors be stockholders.

Filing the Certificate. The incorporators must sign the certificate and acknowledge it before a notary public. It is then forwarded to the secretary of state, together with the filing fee and organization tax, which in respect of par value stock is based on capitalization, and in respect of no par value stock, on the number of shares authorized for issue. The life of the corporation begins at the moment the certificate is filed by the secretary of state, or (in some states) when a certified copy of the charter is filed in the county in which the corporation is to maintain its principal place of business.

The Charter Is a Contract. Most states reserve the right to alter, amend, or repeal all corporate charters, thus

overcoming the effect of the famous Dartmouth College case, in which the Supreme Court of the United States held that a corporate charter was a contract within the meaning of the constitutional provision prohibiting impairment of contract obligations by a state.

Organization Meeting. Shortly after the charter has been filed, the directors usually call a meeting of the stockholders, at which directors for the ensuing year are elected and stockholders' by-laws adopted. The directors, in turn, draft and adopt by-laws and elect the officers of the corporation.

De Jure and De Facto Corporations. Where the mandatory requirements of the statute have been literally or even substantially fulfilled, the corporation is said to exist *de jure* ("according to law"). If some of the requirements have been omitted, or defectively fulfilled, the corporation may nevertheless exist *de facto* ("in fact"), as where the certificate of incorporation omits or incorrectly states the location of the corporate place of business. Such *de facto* corporation can transact whatever business its charter permits, and, with respect to litigation, is in the same position as if it had been organized *de jure.* Only the state (in a direct action of quo warranto) can question the right of a corporation to exist on the ground that it was defectively organized: such issue cannot be raised collaterally in litigation between a *de facto* corporation and a third party. (Of course, if one subscribes to stock in a corporation not yet formed, such subscription implies that the corporation will be organized *de jure;* otherwise the subscribed is under no duty to take and pay for the stock.) Stockholders of a *de facto* corporation enjoy the same freedom from personal liability for corporate obligations as do stockholders of a *de jure* corporation.

Prerequisites for De Facto Corporate Existence. The doctrine of *de facto* corporations has been evolved by the courts to prevent injustice in cases where *de jure* status is lacking because of inadvertent omissions or errors in the procedure followed by the incorporators, but the courts will

refuse to accord even a *de facto* status to such defectively organized corporations unless:

1. *A valid statute* authorizing the formation of the corporation as a *de jure* corporation exists (there is a conflict as to whether this requirement is answered by a statute which, subsequent to the formation of the corporation, is held to be unconstitutional); and

2. *An attempt in good faith* to comply with such statute has been made (i.e., there must be at least a colorable compliance with statutory requirements: minor omissions would be excused, but failure to file the certificate with the secretary of state coupled with the fact that no stock was ever issued, no franchise tax paid, no time fixed for holding a first meeting of incorporators and election of officers, no subscriptions paid for stock, the amount of cash capital named in the certificate never paid in—these omissions would be fatal to the claim of *de facto* corporate existence); and

3. There has been actual *user* of corporate powers (transaction of business as a corporation and under the corporate forms).

Neither De Jure nor De Facto Corporation. Where a body of men (A,B,C), having failed to comply with the requirements for even *de facto* corporate existence, assume nevertheless to act as a corporation, they are generally held to be individually liable on contracts (made on behalf of the nonexistent corporation) either on the theory that they are agents acting on behalf of an incompetent or nonexistent principal, or that they are partners. On the agency theory, one (S) who buys stock in such nonexistent corporation should not be subjected to personal liability unless he participates in the business, whereas under the partnership theory some courts have held that merely signing the articles of incorporation or subscribing to stock is sufficient to make S personally liable to a third person (X) who contracts with the pretended corporation. Where X deals with the pretended corporation he no doubt understands that he is ob-

taining a corporate, not an individual obligation, and for this reason some few courts will not permit X to hold A, B, C, or S liable on the ground that X is "estopped" to deny the corporate existence.

PROMOTERS

A promoter lays the groundwork for corporate existence. His services on behalf of a corporation (not yet formed) may include: making contracts with brokers and bankers for the flotation of stock and bonds; preparation and distribution of a prospectus (containing information as to the nature of the enterprise) and obtaining subscription contracts from investors; drafting the certificate of incorporation and advancing filing fees and organization expenses. He has, in general, no right to receive payment for pre-incorporation services or expenses unless such right is given by statute or by a provision to that effect in the charter, or unless he receives a promise of payment from the corporation. Because of his fiduciary relation to the corporation and its stockholders, he may not buy property and sell it to the corporation at a profit. He may, however, sell to the corporation property owned by him at a time previous to his promotional activities on its behalf, provided he makes full disclosure of its cost and all other facts affecting its value.

Pre-Incorporation Contracts. As to the four grounds suggested to sustain the liability of a corporation upon a contract entered into on its behalf by promoters before its organization — ratification, adoption, novation, and continuing offer — the first is unsatisfactory as postulating an existing person in whose behalf the contract could have been made at the time; the second entails the difficulty that C cannot ordinarily intrude into an existing contractual relation between A and B without consideration moving either to or from him, so as to make a contract as of the date of "adoption" (adoption does not relate back as ratification does); the third is appropriate only if the principles of novation are complied with, including A's release of B and substitution of C; the fourth is perhaps the least incongruous (pre-

organization subscriptions have been regarded as continuing offers), allowing C to accept or reject A's mere "offer" unless it was withdrawn before C came into being. (The distinction between ratification and adoption may be of importance in connection with the Statute of Limitations and the Statute of Frauds. Thus if on January 10, 1940, A orally engages B to work for the X corporation for one year beginning March 1, 1940, and the X corporation adopts the contract on March 1, 1940, the contract is enforceable and not within that provision of the Statute of Frauds which makes unenforceable, unless in writing, a contract not to be performed within a year from its making.)

FOREIGN CORPORATIONS

A corporation is domestic with reference to the state or country in which it was organized, and foreign with reference to any other state or country. Thus the X corporation, organized under the laws of Texas, is a domestic corporation with reference to Texas and a foreign corporation with reference to any other state.

Permitting Foreign Corporations to Do Business. Assume that the X corporation (organized under Texas laws) desires to do local business in New York. It is not a citizen within the meaning of Article IV, Section 2 (1) of the Federal Constitution, which guarantees to the citizens of each state "all the privileges and immunities of the citizens in the several states." Hence the state of New York could refuse to permit the X corporation to do local business in New York under any conditions whatsoever. The power of absolute exclusion includes the lesser power to prescribe conditions under which the foreign corporation will be granted the privilege of doing business. Statutes usually require a foreign corporation seeking this privilege to file a copy of its charter with the secretary of state, pay license fees, and designate an agent on whom process may be served. In addition there may be other requirements depending on the nature of the business (insurance or banking) and the statutes of the particular state in which the

foreign corporation seeks the privilege of doing local business. If the foreign corporation fails to comply with such requirements, the state may provide that it shall not have the right to sue in the state courts on contracts made by it within the state, or that such contracts are void. Of course, if the foreign corporation is sued, it cannot set up its own noncompliance as a defense. In addition to making contracts of the noncomplying corporation unenforceable, statutes prescribe penalties for failure to fulfill the requirements.

The conditions which the state may impose must be reasonable. Having granted the foreign corporation permission to do business, the state cannot refuse to accord to the corporation the equal protection of the law as guaranteed by the Fourteenth Amendment to the Federal Constitution. It may not impose discriminatory license taxes on capital stock, or deny access to the federal courts. Nor may it compel a foreign corporation to comply with registration requirements if such corporation is engaged exclusively in interstate commerce.

What Constitutes "Doing Business." A foreign corporation is doing local business within the state when it transacts there a substantial part of its entire business, and when such local activities have the quality of continuity as distinguished from casual or isolated transactions. Maintenance of a bank account or stock of goods for sale within the state, maintenance of books and records are circumstances which establish or tend to establish that the foreign corporation is doing business within the state.

What Does Not Constitute "Doing Business." The following is a partial list of the activities which have been held not to constitute "doing business" so as to bring a foreign corporation within the scope of registration statutes:

1. *Acts Preliminary or Subsequent to Ordinary Business*: the acquisition or continued holding of local property (and procuring insurance thereon) or of machinery, supplies, and stock in trade to conduct business in another state, the mak-

ing of offers, the solicitation of orders (subject to acceptance later and elsewhere), the making of contracts contemplating future business, and the fulfillment (after the cessation of business) of contract obligations arising out of former business.

2. *Collection of Debts.* Assuming that the transaction out of which the debt arose did not, in itself, amount to doing local business, the corporation may collect the debt in any form or make any compromise (accept property in satisfaction of the debt: it may then sell or lease such property and still not be doing business within the state).

3. *Isolated Transaction.* Engaging in a single transaction (one sale) does not constitute doing business. The element of continuity is lacking.

4. *Litigation.*

5. *Conduct of Internal Affairs* (holding meetings, issuing stock certificates).

6. *Acquisition and Holding Stock of Domestic Corporations.* However, if the foreign corporation by means of such stock ownership controls and dominates the domestic corporation, so that it is in fact the agent of the foreign corporation, the latter will be held to be doing business within the state.

7. *Acting as Trustee* under mortgage or deed of trust where the mortgage covers property within the state.

8. *Ownership and Sale of Property* (as distinguished from its exploitation and development).

9. *Consignments.* Where the foreign corporation consigns merchandise to a factor who bears all the expenses of receiving, storing, and selling the goods, it is the factor who is doing business within the state, and not the foreign corporation. If, however, a nominal consignment account serves merely to mask an agency (as where the foreign corporation pays all the "factor's" expenses of doing business) the courts will hold that the consignor is doing business within the state.

Interstate Commerce. A foreign corporation is engaged in interstate commerce (and hence need not comply with state registration laws) if its activities consist exclusively of:

1. *Mail-Order Business*: orders are accepted at the home office, and goods are shipped into the state direct to the purchaser; or

2. *Personal Solicitation of Sales.* The foreign corporation may employ resident or traveling salesmen who may solicit orders from samples or otherwise — even the maintenance of a sales office within the state will not take the business transacted out of the category of interstate commerce provided no sales, repairs, or replacements are made from stock on hand, which is kept for sample or advertising purposes only, and provided, further, that all orders are accepted subject to approval at the office of the foreign corporation *without* the state, and provided, finally, that all goods are shipped from without the state direct to the purchaser within the state; or

3. *Installation Cases.* Machinery may be delivered into the state under a contract which provides that the seller is to effect or supervise its installation. If the services of an engineer or skilled technician are required for this purpose, the installation is regarded as an integral part of the sale (the buyer would not buy unless the seller agreed to install) and does not constitute doing business within the state. To come within this rule, however, the services must be of a kind not ordinarily available and must be furnished to the purchaser only at the time of construction or installation.

DISSOLUTION OF CORPORATIONS

A corporation may be dissolved by:

1. *Expiration* of the period specified in the charter. Statutes usually provide that after dissolution for any cause, corporate existence shall continue for the purpose of winding up the business and discharging existing obligations and for purposes of suit by or against the corporation.

2. *Action of the Attorney General.* If a corporation has not been organized *de jure,* or if it abuses its powers or makes no use of them, the state (and only the state) can sue to terminate its existence in an action of *quo warranto.*

3. *Surrender of Charter.* The members of a corporation may vote to surrender its charter to the state. On acceptance of surrender by the state, the corporation is dissolved.

4. *Action of Stockholders.* In most states the holders of a certain proportion of the voting stock (two-thirds in New York) can cause dissolution by filing a Certificate of Dissolution with the secretary of the state in which the corporation was organized. As a prerequisite to such filing, all liabilities of the corporation must be discharged. Stockholders can also effect dissolution, in some states, when the directors (being an even number) are deadlocked.

5. *Consolidation.* Corporation A may unite with corporation B to form a new corporation (X). Corporations A and B are dissolved by the consolidation: title to all their property passes to X, and all their liabilities are assumed by X.

6. *Merger.* Corporation A may merge corporation B, in which case only B is dissolved. A absorbs all the property, rights, and privileges of corporation B, but continues its (A's) corporate existence. In some states statutes provide that A assumes all the liabilities of B on merger. If corporation A owns all the stock of corporation B, statutes (like that of New York) may provide that merger can be effected by resolution of the board of directors without necessitating any action on the part of the stockholders of either corporation.

7. *Occurrence of Condition Subsequent.* If the charter so provides, a corporation may be dissolved (without judicial decree or act of the legislature) by the happening of some condition specified therein, but this result will follow only if the charter clearly expresses such intent.

8. *Legislative Repeal under Powers Reserved by the State.* Such reservation may be effected by a provision in the charter or by a constitutional provision or general statute in force at the time the charter is granted, since the reservation by the state of power to "alter, amend, or repeal" the charter is an incident of the contract between the state and the corporation.

Chapter XL

POWERS, LIABILITY, AND MANAGEMENT OF CORPORATIONS

CORPORATE POWERS

The powers of a corporation are either express or implied. An express power is one specifically granted by the charter or by the statute under which the corporation was formed. An implied power is one reasonably necessary and proper to the exercise of an express power.

Express Powers Usually Conferred by Statute Are:

1. To have a corporate name.

2. To own and convey property (real or personal) in such corporate name for corporate purposes and unless prohibited by its charter or by statute.

3. To sue and be sued under such corporate name.

4. To have a corporate seal.

5. To make by-laws.

6. To borrow money for corporate purposes.

Implied Powers Are:

1. To acquire and hold real and personal property for corporate purposes. This power is usually expressly granted by statute or charter. (A manufacturing corporation may buy all raw materials necessary to turn out the finished product, but it may not buy raw materials for the purpose of resale.)

2. To borrow money for corporate purposes. This may be accomplished by issuing bonds with the consent of the stockholders or by pledging unissued stock. The corporation has incidental power to lend money (and to take security therefor) in the prosecution of its ordinary business. The

corporation may not, however, lend money or become a surety or guarantor, unless doing so is clearly necessary to carry out some corporate purpose.

3. To mortgage or pledge its property, as an incident to borrowing money, or to secure debts incurred for corporate objects (consent of a certain proportion of stockholders is frequently necessary to validate a mortgage of corporate assets). A corporation may not, however, mortgage or sell its primary franchise or charter.

4. To acquire, accept, and negotiate commercial paper (checks, promissory notes, bills of exchange) in the ordinary course of its business; but the corporation has no incidental power to assume the obligations of accommodation party for the benefit of a third person (such obligation rests on no consideration and is, moreover, a diversion of corporate funds) and it may be shown that such assumption was *ultra vires* even as against a holder in due course taking with knowledge of the accommodation character of the relationship.

5. To engage in a joint adventure, but not to become a partner, the reason usually given being that the stockholders did not consent to such division of control as the partnership relation implies. This objection would fail if the charter expressly conferred the power to become a partner.

6. The prevailing rule is that corporation A has no incidental power to purchase and hold (or to subscribe for) stock of corporation B, even though the latter was formed for a similar purpose, but this does not preclude A's taking stock of B in payment of (or as security for) a debt, or in return for assets sold (e.g., in connection with winding up).

7. To organize or acquire the stock of a subsidiary which transacts part of its parent's business, but such acquisition of the stock of a competing corporation is an illegal restraint of trade if the purpose is to eliminate competition.

8. To acquire its own stock (being neither insolvent nor in process of dissolution) in good faith (provided this is not

prejudicial to the rights of either creditors or stockholders) as by undertaking to repurchase it or by provisions for its reacquisition upon the death of a member or his desire to alienate or encumber it, or by taking it in payment of a debt or for the release of a subscription. Such stock is not necessarily extinguished thereby (although its voting power is temporarily suspended) but may be reissued.

LIABILITY OF CORPORATIONS

Ultra Vires Acts. An *ultra vires* act is an act which the corporation is not authorized to perform under any circumstances or conditions. For abuse of corporate authority the state which created the corporation may revoke its charter: but no third person, except a member or stockholder of the corporation, may enjoin the threatened commission of an *ultra vires* act. Directors are personally liable to the corporation for any damages sustained by the corporation as a result of an *ultra vires* transaction or contract negotiated by the directors in behalf of the corporation.

Ultra Vires Contracts: Executed and Executory.

1. *Wholly Executed.* An *ultra vires* contract wholly executed on both sides will not be rescinded at the instance of either party to the agreement.

2. *Wholly Executory.* An *ultra vires* contract wholly executory on both sides is unenforecable by either party to the agreement for a number of reasons — the public interest that corporations do not transcend the powers granted, the stockholders' interest that the capital be not subjected to uncontemplated risks, and the obligation of one contracting with the corporation to take notice of the legal boundaries of its powers.

3. *Executed on One Side.* If an *ultra vires* contract has been fully performed on one side, most courts will enforce it against the other party who has received the benefit of such performance, on the ground that it would be unjust to sanction retention of benefit coupled with refusal to perform. Other courts hold the contract unenforceable but compel the party who has received the benefit of perform-

ance to return it or pay its reasonable value. The federal courts formerly followed this minority view, but under recent decisions of the Supreme Court, the federal courts will be bound to decide such cases in the same manner as the courts of last resort of the state in which the federal court is situated.

Liability of Corporation for Torts. A corporation is liable for the tortious acts or omissions of its agents or employees incident to the conduct of the corporate business. In all but a few jurisdictions such liability extends to tortious acts committed in connection with *ultra vires* transactions. Although a corporation has no mind, an intention on the part of its agent to do wrong may be imputed to the corporation. Accordingly, liability for libel and for malicious prosecution has been imposed upon corporations.

Liability of Corporation for Crimes. If personal violence or intent is an element of a crime, it cannot be committed by a corporation. But a corporation can be punished for the violation of some statute or court order which requires or prohibits the performance of certain acts (violation of state or federal income tax laws, anti-trust laws, pure food and drug acts, or the terms of an injunction).

MANAGEMENT OF CORPORATIONS

Directors Manage the Business. Subject to restrictions imposed by statute, charter, or stockholders' by-laws, the right to determine policy and conduct the business lies solely with the board of directors. Provided the directors act honestly, disapproving stockholders have no right to interfere with the management of corporate affairs. Obviously, this subservience is largely theoretical. In practice a group of stockholders can and does dominate by virtue of its power to elect directors who will be amenable to its wishes. If restrictions on the power of directors are contained in the charter, third persons are bound by them, as the charter is a public record. Restrictions embodied in by-laws, however, are not binding upon third persons unless

known to them, as by-laws are not required to be publicly filed or recorded.

Directors Must Act as a Body. The directors can bind the corporation only by action taken at a board meeting. A resolution not passed at a meeting but signed by each individual director at his home would be invalid, unless the directors happened to be the sole stockholders. Directors cannot vote by proxy: their duties are nondelegable. Statutes may provide that the by-laws shall fix a quorum at not less than a minimum number (in New York one-third) of the board. In the absence of such provision, a majority of the board constitutes a quorum, and a majority of a quorum has the power to bind the corporation. Directors have the power to appoint officers, agents, and employees, to make all contracts, and to engage the corporation in all transactions within the purposes for which it was formed.

Fiduciary Relation of Directors to Stockholders. A director must not exploit his office for personal gain at the expense of the corporation and its stockholders, to whom he owes the utmost good faith. What has been said in regard to secret profits withheld by a partner applies with equal force to directors. A director must fully disclose his interest in all contracts. If he casts the decisive vote in a matter in which he is interested, any action taken will be voidable. Some courts hold that this result follows even if his vote was unnecessary, or even if he refrained from voting but was present at the board meeting, notwithstanding the fact that his presence was not necessary to constitute a quorum. Directors may not authorize the issue of unissued stock to themselves for the primary purpose of converting themselves from minority to majority stockholders. Directors are personally liable if they:

1. Wrongfully dispose of corporate assets, or

2. Pay a dividend declared in the absence of profits or surplus (depending upon the applicable statutory requirements as to dividends), or

3. Issue as fully paid, stock which has not been fully paid for, or

4. Lend corporate funds to stockholders.

The fiduciary obligation of directors to the stockholders does not entail liability for business losses incurred because of honest bad judgment not amounting to bad faith or negligence.

Powers of Corporate Officers. The officers of a corporation have only such authority to act on its behalf as may be conferred upon them by the board of directors. With the exception of the president, it is not safe to assume that a particular officer has in fact the authority which is ordinarily associated with his title. The president, however, by virtue of his office has apparent authority to make binding engagements on behalf of the corporation in its ordinary business affairs. Similarly, authority may be found for the proposition that the secretary, as custodian of the corporate records, may certify as to resolutions passed by the board of directors, and third persons may safely rely on the truth of such certificate.

Chapter XLI

CAPITAL STOCK AND DIVIDENDS

CAPITAL STOCK

Capital stock represents the equity of the shareholders in corporate assets. Its amount is fixed by the charter and unaffected by profits or losses. Capital, on the other hand, means net assets of the corporation, which may vary from day to day. Statutes sometimes reverse the usual meanings of these terms (the New York statute defines capital as the aggregate amount of par value stock authorized by the charter plus amounts realized on the sale of no par stock).

Authorized, Issued, and Unissued Stock. The charter fixes the maximum amount of each class of stock which the corporation is authorized to issue. The authorized stock can be increased only by amending the charter. Issued stock is stock that has been issued as full-paid or as part-paid in exchange for cash, services, or property. Unissued stock is authorized stock that has not been issued or forfeited stock (stock issued as part-paid, the stockholder having defaulted in payment of the balance due).

Shares of Stock and Stock Certificates. A share of stock represents an intangible, contractual right of ownership in the corporate assets. A certificate of stock is formal written evidence of the ownership of one or more shares of stock. The share of stock confers only such rights as are founded upon the contract made between the holder thereof and the corporation, and as are found in the charter, which specifies the rights and privileges of each of the different classes of stock (information which, under some statutes, must appear also on the stock certificate). Shares of stock are personal property and, as such, fall within that section

of the Statute of Frauds relating to the sale of goods. Creditors can reach a stockholder's shares only by causing the sheriff to take possession of the stock certificate.

Stock and Bonds. A corporate bond is an obligation to pay a definite sum of money at a future date, at a fixed rate of interest. A share of stock, unlike a bond, does not express an obligation to pay a sum certain in money, but represents a proprietary right in the corporate assets: viz., the right to participate in a final distribution of corporate assets only after all creditors (including bondholders) have been paid. A stockholder ordinarily has voting rights: not so a bondholder, although he may have the right to vote in the event that the corporation becomes insolvent. The sharp theoretical distinctions between bonds and shares often become blurred, and in practice one encounters many hybrid securities.

Classification of Stock. Unless the charter classifies the stock and enumerates the rights and privileges attaching to each class, every share of stock issued by the corporation is the exact equivalent of every other share. The terms "common" and "preferred" acquire definite significance only by reference to the contract which is embodied in the charter, by-laws, and applicable statutory provisions.

1. **Common Stock.** Ordinarily, the contract of the common stockholder entitles him to vote for directors and to share in the profits and in a final distribution of corporate assets on dissolution in proportion to the amount of stock which he owns. More than one kind of common stock may be issued, being designated Class A, Class B, etc.

2. **Preferred Stock.** This designation generally means that a specified class of stock is given some contractual (charter) preference with reference to payment of dividends or distribution of assets on dissolution, or both. More than one class of preferred stock may be issued, usually designated "first preferred," "second preferred," etc., and differing in regard to amount of income, priority of payment, right to control and management, and right to participate in final distribution of assets.

3. **Cumulative Preferred Stock.** The charter may provide that a certain class of stock shall receive an annual dividend at a fixed rate, if such dividend is earned, and that arrears in one or more years shall be paid out of earnings in subsequent years before any dividend is paid on common stock, in which event the stock is said to be "cumulative preferred." If the charter is silent as to cumulation, the general rule is that accrued divi-

dends on preferred stock must be paid before any dividends are paid on common.

4. **Participating Preferred Stock.** The charter may provide that after the preferred stock has been paid its dividend, and the common stock has been paid an equal dividend for the current year, the preferred stock shall participate ratably in any further distribution of dividends with all other classes of stock. It is then said to be participating as to dividends. Similar preferences and rights of participation may be conferred in connection with the final distribution of assets on dissolution.

5. **Callable Stock.** A corporation, only temporarily in need of additional capital, may reserve the option to call in the outstanding stock on payment of a specified price, usually somewhat in excess of par value. Stock subject to such provision is redeemable or callable.

6. **Convertible Stock.** The charter may confer upon the holder of preferred stock an option to exchange it for common at the conversion ratio, that is, the price at which the common is to be valued as against the preferred which is taken at its face value.

7. **Par Value and No Par Value Stock.** Par value stock bears on its face a nominal value: no par value stock bears on its face no value whatsoever. No par value stock may be issued full paid at any price fixed by the directors and the proceeds may usually be allocated to capital stock (or capital, depending upon the nomenclature employed) and surplus in such proportion as the directors deem expedient. No par value stock may be less misleading to some investors than par value shares as no par shares purport to represent nothing more than a certain proportion of the equity or stock ownership. Since no nominal value appears on the certificate, the holder cannot, as he may in the case of par value stock, infer that the nominal value is the same as the actual value.

The Capital Stock Is a "Trust Fund." Creditors have the right to assume that stock, issued as fully paid, has in fact been fully paid in cash, property, or services rendered (not prospective services). Where directors have wrongfully issued as fully paid, stock for which the equivalent in cash, property, or services has not been received, not only the directors but also those to whom such "watered" stock was issued may be held liable to creditors of the corporation in the event of its insolvency. The liability of the stockholder for the amount unpaid on his stock under such circumstances may be grounded on either of two theories:

1. **The Trust Fund Theory,** which asserts that the capital stock is a trust fund to be maintained unimpaired and to be used to pay corporate creditors; or

2. **Estoppel:** issued, full-paid stock has been "held out" to creditors as representing capital contributions actually received.

and creditors whose claims arose after the issuance of bonus or watered stock have therefore been misled by such misrepresentations on the part of the stockholders.

Similarly, D, transferee of stock from A (original subscriber) with actual or constructive notice that it was not fully paid up, is liable to creditors to the extent of the amount unpaid.

DIVIDENDS

Right to Dividends. Even though the corporation has earned current profits and has a surplus, the directors are not bound to declare a dividend. If in their honest judgment they reasonably determine that the profits should be kept in the business, no court will compel them to make a distribution to stockholders. However, if directors declare a dividend, stockholders have the right to their pro rata share. Once publicly declared, a dividend may not be rescinded: it becomes a debt to the stockholders entitled to receive it.

When Dividends May Be Paid. In general, dividends cannot be declared when their payment would result in impairment of capital, that is, so long as the books show a deficit. Whether it is permissible to wipe out such deficit by an honest upward revaluation of assets, thereby converting deficit into surplus, is not entirely clear. In the case of corporations engaged in the exploitation of mines, oil wells, or other mineral resources ("wasting assets") dividends may be paid notwithstanding the fact that, to some extent at least, such dividends represent a return of capital investment to the stockholders.

Two Major Dividend Policies. Two major variations of policy are reflected in statutory provisions governing the conditions under which a solvent corporation may declare and pay dividends:

1. **Dividends Payable Only Out of Surplus.** (Surplus=assets−[liabilities + capital stock.]) One group of states permits declaration of dividends only if a surplus exists. Thus, the X corporation may realize current profits and yet not be permitted to pay a dividend until it has eliminated a deficit resulting from its operations in previous years. On the other hand, if the X corporation has a surplus it may, under this view, properly pay a dividend although realizing no profit from current earnings. The

theory is that the capital stock constitutes a "trust fund" for the protection of creditors, and that this fund must not be impaired. Analogous statutes permit dividends to be paid only out of net profits made at any time since the corporation was organized.

2. **Dividends Payable Only Out of Current Earnings.** Under this rule a corporation may have a surplus and yet not be in position to declare a dividend, owing to the fact that no profit has been realized on current operations.

Recovery of Dividends Illegally Paid. "Insolvency" may mean excess of liabilities over assets (capital stock not being included in liabilities) or it may mean inability to meet current obligations as they mature. In either case the payment of dividends would be unlawful and a fraudulent transfer of assets to stockholders which corporate creditors could set aside, and this is equally true where the payment of the dividend results in insolvency. Such payments must be returned by the stockholders even if received in good faith. Where, however, mere capital impairment (as distinguished from insolvency) results from an improper payment of dividends, stockholders may retain the payments unless received in bad faith. Directors are civilly liable to creditors for an improper declaration of dividends in the event of the subsequent insolvency of the corporation. Most states also impose criminal liability on directors for illegal dividend payments.

Chapter XLII

RIGHTS AND LIABILITIES OF STOCKHOLDERS

RIGHTS OF STOCKHOLDERS

The following is a résumé of the more important rights of stockholders based upon typical statutory and charter provisions and in some instances founded upon court decisions.

Voting for Directors. Each share of stock has one vote. Since charters usually provide that preferred stockholders shall not have the right to vote for directors, the power to elect the entire board of directors lies with those stockholders of record who own or control a majority of the common stock. Directors are usually chosen by a plurality (rather than a majority) of votes cast at an election held at the time and place fixed by the by-laws of the corporation. A stockholder may vote in person or by proxy, The Securities and Exchange Commission has put into effect severe regulations governing the solicitation and content of proxies (written authorizations to vote for stockholders).

Cumulative Voting. In order to secure to minority stockholders representation on the board of directors, statutes of some states, and some charters or by-laws, provide that a stockholder may multiply the number of voting shares which he owns by the number of directors to be elected, and may cast the total number of votes thus obtained for a single candidate, or distribute the total number among the candidates in any proportion which he desires.

Voting Trusts. A group of stockholders may, in some states, transfer their individual holdings to a trustee, so that the trustee shall have the power to vote as a unit all stock thus pooled. The trustee issues to the stockholders who

form the pool certificates of beneficial interest as evidence of their continued ownership (for all but voting purposes) of the stock transferred. Voting trusts are an effective device for gaining control and insuring stability of management, but some states hold such agreements void on the ground that it is against public policy to separate voting power from beneficial ownership. If the voting trust is valid under the laws of a particular jurisdiction, it is irrevocable during the term specified in the agreement.

Acts Requiring Approval of Stockholders. Statutes may require the consent of holders of a majority or of two-thirds of the shares entitled to vote in order to validate certain corporate acts. Thus, the New York statute requires:

Consent of Majority to:

Change number of directors.

Change location of its office.

Increase or reduce amount of capital stock where it consists solely of par value shares.

Consent of Two-thirds to:

Change purposes.

Classify or reclassify any shares, either with or without par value.

Mortgage property, real or personal, except a purchase money mortgage.

Guarantee the bonds of any other corporation engaged in the same general line of business, if the guarantor corporation owns a majority of the voting shares of such corporation; if not, unanimous consent is required.

Terminate the business or corporate existence by: Sale of all the assets, or Consolidation, or Dissolution.

Pre-emptive Rights. A stockholder is entitled to maintain his proportionate degree of control of the corporation, and his proportionate interest in the surplus. If an amendment to the charter authorizes an increase in the capital stock, stockholders must first be given the right to subscribe to such new issue in proportion to their present holdings before the new stock is offered for sale to the public. Thus, if the X corporation has 2,000 shares of Class A common voting stock authorized and outstanding and by charter amendment increases this class of stock by 1,000

shares, there will be 2,000 "rights." If Mr. Jones owns 100 shares of the Class A common, he must be given the first opportunity to purchase 50 of the new shares at the price and within the time stipulated. The states differ as to whether the price may be fixed at more than par value. The pre-emptive right does not apply:

1. To the sale of unissued stock or treasury stock.
2. To the exchange of newly issued stock for property.
3. To stock which is nonvoting and nonparticipating (because such stock would be unaffected by dilution of control or surplus).

The pre-emptive right may be waived by provisions in the charter or by-laws, or by express contract.

Stockholders' Representative Action. Where the officers or directors are about to enter into *ultra vires* contracts or transactions involving an illegal or fraudulent transfer or impairment of corporate assets, a stockholder must first endeavor to secure appropriate action by the board of directors. If his efforts to that end are futile, he may then commence an action in equity on his own behalf and on behalf of all other stockholders similarly situated, against the officers, the directors, the corporation, and third persons participating in the wrongful transaction; and he may obtain such relief by way of injunction, accounting, or otherwise, as the circumstances may warrant. The final decree in such action will require restitution or compensation to be paid *to the corporation* by the wrongdoers, thereby indirectly benefitting the injured stockholders. It will be observed that the corporation, although reaping the direct benefit of such stockholders' representative action, is a nominal defendant. This results from the unwillingness of the directors to take any action on its behalf.

Right to Information. The stockholder has a right to certain information in regard to corporate affairs, and to that end he may insist upon reasonable opportunity to examine books of account, stock books, and other corporate records. In many states his right to inspect books and records is given a precise statutory content with respect to the time

and place where such examination is to be permitted. This absolute statutory right of inspection may be supplemented by court order granting a more extensive inspection if it appears that the stockholder's motive is a proper one.

LIABILITIES OF STOCKHOLDERS

Possibly the most important distinction between a partner and a stockholder lies in the fact that a stockholder (holding stock that is "fully paid and nonassessable") is not personally liable for corporate debts and obligations. If, by statute or charter, the stock is assessable, the directors can call for additional payments by the stockholders, notwithstanding the fact that their stock has been fully paid for. Such assessments may be made to meet corporate obligations. Stockholders in national banks were formerly subject to double assessment, that is, liable to make good capital impairment or claims of creditors up to the face amount of stock held by them; and many states imposed similar liability on stockholders in state banks. However, stockholders of national banks have been relieved of this liability under legislation creating the Federal Deposit Insurance Corporation in 1933, and many states have similarly abolished double liability of bank stock.

Some statutes impose personal liability on stockholders for laborers' and employees' wages notwithstanding that their stock has been fully paid for and is nonassessable. This liability, of course, can be enforced only after remedies against the corporation have failed, or in the event of the insolvency of the corporation.

Subscription to Stock: Before Incorporation. A subscription is an offer to buy stock. A, B, C, D may subscribe to stock of the X corporation thereafter to be organized. Such subscription has a double aspect: It is the contract of A, B, C, D; it is, also, a continuing offer to buy stock addressed to a legal person not yet in existence. Two views as to the nature of this offer are to be found in the decisions and statutes of the various states:

1. The offer is revocable at any time before it has been accepted by the corporation;

2. The offer is irrevocable (unless canceled by consent of all the subscribers before acceptance by the corporation).

Similarly, divergent views obtain as to what constitutes acceptance of a subscription. Some courts deem the offer accepted the moment the corporation comes into existence. Others require express acceptance (as by the issuance of stock certificates to the subscribers) or acceptance implied from the fact that the subscriber has been permitted to exercise the rights of a shareholder.

Subscription to Stock: After Incorporation. A may contract to buy at a specified time stock of X, an existing corporation, in which event A would become liable in damages for failure to purchase as agreed. If the contract provides for the issuance of par value stock it must obligate A to pay the full par value, in cash or property, either immediately or by deferred payments at a specified future time or on demand (on "call"). If, however, A makes a present subscription contract, he becomes liable at once for the full price of the stock. If A defaults after making part payment, and before delivery to him of the stock certificate, the X corporation may, in most states, exercise lien or forfeiture rights against A's shares.

Transfer of Stock. Ownership of shares is evidenced by a stock certificate. When the X corporation issues a certificate for 100 shares to A an entry is made in the stock book and A is said to be a "stockholder of record." Shares of stock are intangible personal property and are transferable by endorsement and delivery of the certificate. However, if A endorses his certificate to B the corporate records should reflect the change in ownership; otherwise, A would be in a position to vote the stock and receive dividends. Hence, B should surrender A's endorsed certificate to the X corporation for cancellation, obtaining a new one in his (B's) own name, and appropriate entries must be made in the stock book to the end that B instead of A may appear as the stockholder of record. If A's endorsement is forged, B ac-

quires no title to the certificate. Accordingly, it is customary to require a banker or broker to guarantee the genuineness of the endorsement as a condition to the issuance of a new certificate to the transferee.

1. **Transfer Agent and Registrar.** All corporations whose stocks are listed on the New York Stock Exchange must designate a transfer agent to make transfers and keep the transfer books, a task which in small corporations is performed by the secretary. In addition to the appointment of a transfer agent the Exchange rules require the corporation to maintain a registrar (usually some bank or trust company). The registrar must determine whether each new certificate to be issued is valid and not in excess of the number of shares authorized by the charter.

2. **Negotiability of Stock Certificate.** The Uniform Stock Transfer Act makes stock certificates negotiable and in states which have adopted the Act a stock certificate endorsed in blank passes like bearer paper. A thief or a finder of a certificate endorsed in blank accordingly has the power to give good title to a bona fide purchaser for value, thereby extinguishing the rights of the original owner.

3. **Restrictions on Transferability.** Stockholders may agree or pass a by-law to the effect that if any one of them wants to sell his stock he must first offer it to the other stockholders. If A, (a stockholder) in violation of such agreement, sells his stock to X, who does not know of the restriction, X will not be bound thereby unless notice of the agreement or by-law appears on the stock certificate.

4. **Repurchase Agreements.** Agreements made by a corporation to repurchase stock held by an officer on the termination of his services to the corporation have been held illegal on the ground that such an agreement might require the corporation to buy its stock when it has no surplus.

5. **Right to Dividends as between Transferor and Transferee.** The corporation determines stock ownership by its stock book and pays dividends to the record holder of the shares, but as between A (transferor) and B (transferee) the dividend belongs to the owner of the stock at the time the dividend was declared. Thus, if A assigns his certificate to B and a dividend is declared after the transfer, the dividend belongs to B, although the transfer has not yet been registered on the books of the corporation. In the absence of notice of the transfer, the corporation would be justified, however, in paying the dividend to A, the record holder. Hence, the importance of promptly registering a transfer: (1) To prevent (in the case of partly paid stock) A's liability for further calls, and (2) To insure payment of dividends to B.

Liability Incident to Transfer of Stock.

1. Bona Fide Transfer Discharges Liability of Transferor. A may make a bona fide sale to B of stock which has not been fully paid for. There is a conflict of

authority as to the effect of such transfer, many courts holding that it operates as a novation, A's obligation to pay the balance being discharged by the substitution of B as obligor to the corporation. (The transfer is given this effect, however, only as of the date that it is recorded in the corporate books.) Under the statutes of some states A's liability to creditors (in the event of the corporation's insolvency) is continued to the extent of the unpaid balance due on the stock. If partly paid stock is issued to A, but through some error the certificate is marked "fully paid and nonassessable," the corporation cannot collect the balance due from one who, in good faith, purchased the stock from A.

2. Transfer Made in Bad Faith Does Not Discharge Liability of Transferor. No court will recognize as valid a transfer by A to B where B is financially irresponsible and A's sole purpose is to escape liability for future calls, the stock being worthless or worth less than the balance due. If A transfers to B stock on which calls have been made but not paid, A continues to be liable therefor. It would seem that B, too, is liable if at the time the certificate was transferred to him he knew of the unpaid calls.

Chapter XLIII

OTHER FORMS OF BUSINESS ORGANIZATION

Individual Proprietorship. There is no special branch of the law relating to the sole trader, whose business transactions are governed by principles of Contract, Tort, Agency, etc. Thus, the capacity of a married woman or an infant to engage in business as an individual trader would ordinarily depend on such person's contractual capacity in the given state. Where one does business under a trade name, many states require the filing of a trade name certificate setting forth the true name and address of the person about to conduct business under an assumed name. Some statutes prohibit the use of "& Co." unless more than one person has a proprietary interest in the firm. The right to engage in any lawful business or calling is within the scope of the constitutional guaranty assuring to "the citizens of each state all the privileges and immunities of citizens in the several states." This provision would apply to a natural person doing business as a sole trader in any part of the United States, but would not apply to a corporation, the latter having been held not to be a citizen within the meaning of this particular clause. The sole trader enjoys privacy in the operation of his business, receives the entire profit, but, on the other hand he cannot limit his liability to creditors. Ordinarily he lacks the facilities (which the corporate form possesses) for obtaining large amounts of capital.

Limited Partnership. The limited partnership act of New York (1822), contemplating one or more general partners (A), and one or more special (or limited) partners (B) contributing to capital a specific sum *in cash*, enabled an investor to share the profits of a non-corporate enterprise without personal liability to its creditors;

but it was held (under that statute and under similar acts passed, and still in force, elsewhere) that the statutory conditions must be meticulously and exactly observed if such immunity were to result — even a minor infraction or deviation, such as an unintentional misstatement (as to a trivial matter) in giving the detailed information required in the certificate, was fatal, and the unlimited liability of a general partner resulted. If payments to B, ostensibly as compensation or profits, were found later to be a withdrawal of his contribution to capital, he was liable to creditors (at least to the amount thereof), and he was liable without limit where he interfered in the conduct of the business further than to exercise privileges specifically permitted by the statute.

The Uniform Limited Partnership Act (adopted in upwards of twenty states) provides for a limited partnership upon substantial compliance in good faith with the requirements of a (sworn) certificate (if not so formed, one believing he has become a limited partner [provided such belief, though mistaken, is bona fide] may avoid liability as a general partner by promptly renouncing his interest in the profits or other income) and specifies the circumstances wherein B (who may contribute cash *or* property) may receive compensation. B may claim as a creditor for advances or loans. His interest as special (or limited) partner is assignable. He has the right of full information as to firm affairs and of access to firm books. He is liable as general partner if he takes part, in name or in fact, in the control of the business beyond the exercise of his rights and powers as special partner.

Limited Partnership Association. This hybrid statutory device provides for limited liability of all members whose ownership of the business is evidenced by transferable shares. However, a transferee acquires no right to participate in the business until elected to membership. If not elected, he can compel the firm to purchase his shares at their appraised valuation. An elected board of managers functions

like the board of directors of a corporation. The statute requires that contracts involving more than a specified amount must be signed by two of the managers. This form of association, which seemingly possesses no advantage over the corporation (except, possibly, in regard to taxation), is permitted by statute in a small number of states.

Joint Adventure or Syndicate. A joint adventure is an association of two or more persons under a contract, express or implied (each contributing something and sharing in profits and losses, and having joint proprietary interest and right of mutual control) to carry out a single transaction or series of transactions. Like general partners, joint adventurers are fiduciaries and liable without limit for all obligations properly incurred. There is a conflict as to whether or not the principle of *ostensible* authority enables one joint adventurer to bind the others — it has been said that his authority to bind them must have been *actually* (expressly or impliedly) conferred upon him.

Joint Stock Company. A joint stock company is an unincorporated association formed under voluntary agreement (articles of association) to carry on a business for profit with perpetual succession and a capital stock divided into transferable shares. It is comparable with a partnership but without either *delectus personarum* or authority in its members to bind it by action. Each associate is liable without limit for debts of the association (but may by withdrawal avoid liability for subsequent debts). The business is conducted by an elected board of managers or directors. The company sues or is sued in the names of its members, but some statutes provide more convenient means of designation (in New York such company may sue and be sued in the name of the president or treasurer, if it consists of seven or more persons).

Common Law, Massachusetts, or Business Trust. In this form of association those who contribute the capital and property transfer the legal title to trustees elected to serve for the duration of the trust. The trustees issue to the contributors certificates of beneficial interest. The shareholders

will be held individually liable as partners if they have reserved to themselves the power to remove or control the trustees, or if they reserve the power to appoint new trustees (except in case of death or mismanagement). Otherwise, they will enjoy limited liability. In a business trust the relation between the parties is that of trustee and beneficiary, not principal and agent. The subscribers must have neither direct interest ownership nor control of the property and affairs of the trust.

Part VIII: Security Devices

Chapter XLIV

POSSESSORY LIENS

INTRODUCTORY

A security device reduces the credit risk. Something more than the ordinary collection machinery (judgment, execution) is available to the secured creditor. If his security is adequate he will be able to realize 100 cents on the dollar in the event of his debtor's bankruptcy. Thus, the secured creditor may have a lien giving him the right (not enjoyed by the unsecured creditor) to subject specific property to the payment of his claim, or he may have the right to enforce a guarantee of performance or payment made by some third party.

COMMON LAW LIENS

One of the oldest forms of security is the possessory lien (arising by implication), which gives L (the lienor) the right to retain possession of certain property belonging to O (the owner). At common law this right arose in favor of innkeepers, common carriers, public warehousemen, and artisans — provided the latter, by their labor and materials, enhanced the value of the property on which they worked. (L, a jeweler, has a lien on O's watch for the fair value of repairs; but L, a printer, has no lien on type supplied by O for the fair value of L's services in printing a book for O. If O had supplied the paper, L would have a lien on the printed pages.) This common law lien is a right of *continued possession* by L as security. If L returns the property to O (except for some temporary purpose) his lien is destroyed; nor is it revived if O at some future time redelivers the property to L for further repairs or services. The lien is not assignable and L (at common law)

has no right to sell the property to satisfy his claim. L has merely the right to withhold possession from O, a right aptly described as a mere "worrying asset" having a "nuisance value." The lien is discharged by discharge of the debt which it secures or by a tender of the amount due. If, after such tender, L refuses to return O's property, L is guilty of conversion.

Extent of Lien. Assume that L has in his possession two watches belonging to O and that he repairs both; that the fair value of L's labor and materials are: as to watch No. 1, $3, and as to watch No. 2, $4. L delivers watch No. 1 without receiving payment. He refuses, however, to deliver watch No. 2 unless O pays him $7. L misconceives his rights. He has a lien on watch No. 2 for $4. His (artisan's) lien is said to be *specific;* that is, it secures only the debt which arose in connection with the work done on watch No. 2. By contrast, a factor (commission merchant) has a *general* lien on goods in his possession and belonging to his principal, for all advances made or expenses incurred (*not* necessarily in connection with a particular consignment) by the factor on behalf of his principal. A banker has the analogous right to set off against a depositor's balance all (matured) debts owed by the depositor to the banker. (A broker, however, does not have a general lien on his customers' securities.) A lawyer has a general lien on his clients' papers. An innkeeper's (special) lien extends not only to property owned by his guest but to property owned by third persons and brought "infra hospitium" (into the hotel) by the guest, provided the innkeeper had no notice of such ownership and acted in good faith. A warehouseman, on the other hand, cannot assert his lien for storage charges against the property of third persons in his possession.

Common Law Lien Implemented by Statute. The scope and effectiveness of the common law possessory lien have been increased by statutes providing:

1. That despite a surrender of possession a lienor can preserve his lien by filing notice thereof in the manner prescribed. (In some states the lien may be preserved without filing any notice as between lienor and debtor, but the lienor may lose his

priority over a conditional vendor or chattel mortgagee if the property remains out of his possession for more than a specified period [thirty days under Sec. 184, New York Lien Law, which defines the lien of a garage proprietor on a motor vehicle for repairs, storage, gasoline, etc.])

2. That on the default of the debtor, the lienor, having given due notice to the debtor and having advertised the sale in some newspaper, has the right to sell the property at public sale. Any surplus remaining (after deducting an amount sufficient to cover the debt, interest, and all expenses incidental to sale) belongs to the debtor. If the sale results in a deficit the debtor remains liable therefor.

PLEDGE

A pledge is a bailment for security. The lien of the pledgee cannot arise until the debtor or borrower delivers the property to the pledgee as security. If, because of the bulk of the property or for some other reason, manual delivery is impracticable, a symbolical delivery will suffice (delivery of the keys to a safe deposit box).

Property Subject to Pledge. Pledges usually involve property which can be delivered manually: collateral security (negotiable instruments, negotiable documents of title to goods, bonds, stocks, etc.). The pledgee of a negotiable instrument or document will be deemed a holder in due course to the extent of his lien if he satisfies the requirements of such holder.

1. **Pledge of Warehouse Receipts.** A warehouse receipt is a receipt for goods deposited with a warehouseman. If negotiable in form, such receipt is a symbol of the goods described therein, and may be dealt with in their stead. It serves as a prime base for the extension of credit against merchandise stored in cold storage warehouse, general merchandise storage warehouse, or field warehouse (used exclusively in connection with goods stored for credit purposes). Since a warehouseman is not responsible for loss or damage caused by accidental fire, banks lending against warehouse receipt collateral insist on the borrower's furnishing adequate insurance coverage. Similarly, a warehouse receipt does not carry an implied warranty as to the grade or quality of the goods. The lender must obtain grade or quality certificates from expert testers if he is to have adequate assurance as to the value of the collateral. Finally, the lender takes the risk that the goods described in the receipt were stolen, in which event he cannot hold the warehouseman liable. A negotiable warehouse receipt (like any other negotiable document) may be in such form as to be negotiable by a thief or a finder, but the warehouseman does not warrant the depositor's title to the goods described therein. The Uniform Warehouse Receipts Act has been adopted by every state in the union except New Hampshire. It defines with precision the rights and duties of warehousemen and holders of

warehouse receipts, and prescribes certain information which every receipt must contain.

2. Pledge of Accounts Receivable. D may assign to C as security D's account or claim against X. The incidents of such assignment have already been set forth. The term "factor" or "commercial factor" is in general use to designate a concern which lends money against the security of accounts receivable. Factors are said to operate on a "notification" or "non-notification" basis, depending on whether or not they notify the debtor that his account has been assigned. Where D assigns accounts to C as security the assignment will be deemed fraudulent as to D's creditors if D reserves dominion over the accounts assigned or over the proceeds thereof.

Pledgee's Lien. The pledgee's lien, unless otherwise agreed, secures only the debt for which the pledge was given. Collateral notes, however, customarily contain a provision to the effect that the collateral shall secure not only the debt evidenced by the note, but all other obligations (matured or unmatured) of D to C. Other common provisions give C the right to sell the collateral whenever he "deems himself insecure," to sell without notice, at public or private sale, and permit C to buy at such sale. (The objection to C's purchasing the collateral himself, in the absence of such express agreement, lies in the conflict between his desire to pay as little as possible and his duty to realize as much as possible on the sale.) The pledgor cannot, however, effectively agree to relinquish his right of redemption, such agreement being contrary to public policy, as it would result in a forfeiture of the property pledged as security; but by contract upon separate consideration *after* the original pledge he can effectively surrender his right of redemption. The right to redeem may be exercised at any time before the property is sold on payment of the amount due including all expenses incurred preparatory to sale. Even in the absence of an express provision a pledge confers upon C the right to sell upon D's default, differing in this respect from other common law possessory liens. As indicated above, however, unless the pledgor waives them, common law or statutory requirements as to notice and conduct of the sale must be strictly complied with. Otherwise, the pledgee will be liable in conversion. The pledgee incurs such liability also where he sells the security before maturity of the debt. He is not

liable, however, for refusal to sell security the value of which is rapidly declining: it is his privilege to do nothing, and the pledgor cannot force a sale or redeem the security before the debt matures, in the absence of an agreement framed to meet such contingency.

Pledgee Has No Right to Sell Commercial Paper. One exception to the pledgee's right of sale must be noted (in the absence of special agreement): where the security consists of commercial paper, because the public sale of such negotiable paper would involve too great a loss to the pledgor. The pledgee may, of course, collect the notes and apply the proceeds to the debt which they secure.

Broker's Lien. A broker (B) advancing money to a customer (C) to enable the customer to buy stocks or commodities on margin, has a specific lien on the stocks or commodities pledged by the customer to secure such advances. B has no right to repledge the property, and in some states a repledge of stock by B to secure a debt greater than B's lien constitutes a criminal offense. C, however, usually gives the broker a general lien by agreement, waives notice of sale, assents to public or private sale, and gives the broker permission to repledge his stock "in block." (B borrows $50,000 from X. As security for the loan he pledges the stock of C, D, E, F — all margin customers — in block, that is, as a unit.) Stock or commodity exchange rules are applicable to every margin purchase made on such exchange.

Chapter XLV

NON-POSSESSORY LIENS

A number of security devices depend for their efficacy upon compliance with statutory provisions varying greatly in detail but having in common one requirement: the filing or recording of a notice of security interest. So far as creditors are concerned such public record serves the same purpose (notoriety) as possession in the case of a common law lien: it gives notice to anyone dealing with the owner that certain property is subject to some security interest, and since public records are accessible to all, the law will treat persons dealing with the owner as if they were informed of all facts a diligent search would have revealed, whether or not such search has in fact been made (constructive notice).

MECHANICS' LIEN

The mechanics' lien is a statutory device for the protection of one who furnishes labor or materials for the improvement of real property.

Persons Protected. The construction of a building usually gets under way in the following manner. The owner of real estate contracts with a general contractor to erect a building in accordance with certain plans and specifications prepared by an architect who is to superintend its construction. The general contractor sublets various portions of the work (excavation, electrical wiring and fixtures, carpentry, painting, plumbing) to subcontractors. Laborers are employed and materials purchased for the job. The mechanics' lien statute protects the contractor, the subcontractors, the architect, laborers, and materialmen.

Extent of Lien. State laws vary as to the extent of

the lien. Some states, like New York, limit the lien of subcontractors, laborers, and materialmen to an amount not "greater than the sum earned and unpaid on the contract between the owner and the contractor at the time of filing the notice of lien, and any sum subsequently earned thereon." But the owner will not obtain the benefit of such provision if he makes payments to the contractor with knowledge of the fact that claims for labor or material are unpaid, or after notices of liens for such claims have been served upon him. Statutes of this type usually require the owner, before making any payments to obtain from the contractor a sworn statement setting forth the names of all creditors and the amounts due or to become due to each, and to retain funds sufficient to cover such claims, and claims for which notices of lien have been filed. The owner may rely on the truth of such statement, and is not liable for more than the amount retained notwithstanding the fact that the contractor may have falsified the statement in order to obtain a larger payment than he was entitled to. If the sum retained is insufficient, laborers' claims are preferred: other creditors share ratably.

In other states liens of subcontractors, laborers, and materialmen are not limited to the amount due the contractor under the construction contract, but are enforceable in full against the improved real estate.

Diversion of Funds Larceny. The New York statute impresses certain moneys arising out of the improvement with a trust in favor of claims for labor and material. Thus, an owner who sells the property, or receives funds under a building loan or construction mortgage, or under an insurance policy by reason of the destruction of the improvement, may be guilty of larceny unless he uses the moneys so received to pay the cost of the improvement. Similar criminal liability attaches to a wrongful diversion by a contractor or subcontractor of funds received under the building contract.

Filing Requirements. Under some statutes the lien attaches when the contract is entered into, but under others the lien does not attach until the notice of lien is filed. Filing

must take place within a specified period (usually "within four months after the completion of the contract, or the final performance of the work, or the final furnishing of the materials, dating from the last item of work performed or materials furnished"). Under the New York statute all liens are on a parity irrespective of the time order in which they were filed, except that laborers' claims are preferred and that claims of laborers, subcontractors, or materialmen (with respect to the proceeds derived from the sale of the improved real estate) have preference over claims of the persons to whom such labor and materials were furnished.

Interests Affected. The lien may attach to any interest in real estate, from leasehold to fee, depending upon the circumstances. If a lessee contracts for the improvement without the consent or knowledge of the owner, only the lessee's interest can be subjected to the lien. A pre-existing mortgage has priority over liens with respect to the value of the property minus the improvement, but many states refuse to extend this priority to the improvement at the expense of the lienors, giving the liens priority as to the improvement, if segregation of values is possible. Where a construction mortgage is given some statutes (New York) limit its priority to advances made before the filing of notice of lien.

Lien for Materials Furnished. One who claims a lien for materials furnished must prove that such materials were delivered to the premises. No lien can be claimed for material sold to the contractor on his general credit: in such case the contractor is deemed to furnish the material himself — he becomes his own materialman. Hence, a materialman should keep records enabling him to prove exactly what materials were delivered on each particular job.

Foreclosure. A lienor may enforce his lien by a foreclosure action in which the court will order a sale of the property and distribute the proceeds among all lienors and junior encumbrancers who may be entitled to share therein.

Waiver of Lien. The contractor may waive his lien

by agreement, thereby waiving as well the derivative lien of subcontractors if (as some statutes provide) such waiver is recorded before subcontractors have done any work on the improvement.

CHATTEL MORTGAGE

A chattel mortgage is an instrument by which the mortgagor (debtor) transfers to the mortgagee (creditor) a security interest in personal property. In many states the theory is that a defeasible title passes under the mortgage and reverts to the mortgagor on payment of the debt. In practice, it makes little difference whether the mortgage be conceived as creating a lien or as passing a defeasible legal title. When the debt to be secured is the purchase price, or some part thereof, the mortgage is known as a purchase money chattel mortgage.

Recording or Filing Mortgage. The validity of a pledge depends on continued possession by the pledgee. But a chattel mortgage does not require a delivery of the mortgaged property to the mortgagee. If the mortgagor retains possession the apparent situation remains unchanged. Third persons may purchase the property from the mortgagor or extend credit to him unaware of the mortgagee's security interest. It is not the policy of the law to uphold secret liens; hence statutes generally provide that a chattel mortgage shall be void as to bona fide purchasers for value and without notice of the mortgage, and as to lien creditors (attaching or judgment creditors who have levied execution on the mortgaged chattels) of the mortgagor unless:

1. The mortgagor makes an immediate delivery of the property to the mortgagee, who continues in its possession; or

2. The mortgage is recorded or filed (some states require filing or recording within a prescribed time) in the place in which the mortgagor resides (and where he has a usual place of business, if in a different place) or (in some states) in the county in which the property is located at the time of execution of the mortgage. In order to be filed or recorded the mortgage must be executed and acknowledged

before a notary public or other public officer in conformity with statutory requirements. (In some states this is the only way whereby the creditor can secure protection.)

In some states (New York) if the mortgagor remains in possession and the mortgage is not filed or recorded within a reasonable time, it is void even as against creditors whose claims arose prior to the execution of the mortgage (antecedent creditors) and as against those who extended credit to the mortgagor with knowledge of the mortgage but before it was filed. If the mortgagor, with the consent or knowledge of the mortgagee, removes the property from one county or state to another, the mortgagee should comply with the recording or filing requirements which obtain in the new location.

Crop Mortgages. Property must have actual or potential existence to be the subject of a chattel mortgage. When crops are planted, they have potential existence. Similarly the increase of a herd of cattle has potential existence. Both the crops and the increase may be mortgaged. Many states however, disregarding the requirement of potential existence, recognize the validity of a mortgage on future crops not yet planted, provided that the mortgagor does not sell or lease the land before the crops come into being.

Mortgage on After-acquired Property. An attempt by A to create a mortgage on property which he does not own may take effect by way of estoppel if he later acquires title, and a mortgage of property to be acquired is, in some cases, enforceable in equity.[1] In many states a mortgage on future goods (which expressly or by implication permits the mortgagor to sell goods presently owned by him and embraced in the mortgage) is void as to subsequent creditors of the mortgagor. Some statutes prescribe special steps to be taken by one who desires to obtain a lien on a shifting stock of goods (filing the agreement for lien and posting in a con-

1 The New York courts have held incongruously that such (recorded) mortgage is good against a purchaser in good faith with no actual notice thereof, but invalid as against an attaching creditor.

spicuous place where the goods are kept a notice that they are subject to a lien, setting forth the name and address of the lienor).

Mortgage to Secure Future Advances. Assume that A mortgages machinery to B to secure a present advance of $1,000 and additional future advances not exceeding $5,000, which B agrees to make within a specified time. B duly records his mortgage. Before B makes any further advances, C lends A $1,000, taking as security a mortgage on the same machinery. C records his mortgage. Unless B acquires actual knowledge of C's mortgage, further advances made by B up to $5,000 will be protected by the same priority which attached to B's initial $1,000 loan; that is, B's mortgage to the extent of $6,000 will be prior to C's mortgage. B should not be charged with constructive notice of C's lien, as B was not bound to search the record after he obtained and recorded his mortgage. But assume that C had notified B of his mortgage before B made further advances to A. Since B had contracted to make such advances, it would seem that he is entitled to priority even if he makes them with knowledge of C's mortgage. On the other hand, if B has merely the option (as distinguished from the contractual duty) to make future advances, B will not be given priority over C where B makes such advances with knowledge of C's mortgage.

Consent to Sale. The mortgagee waives his lien by consenting to a sale by the mortgagor, or by conferring on the mortgagor general authority to sell. If, however, the mortgagee makes the mortgagor his agent to sell the property, the lien of the mortgagee will attach to the proceeds of such sale.

Foreclosure of the Mortgage. The mortgage may give the mortgagee the right to take possession of the property and sell it on default of the mortgagor. Such sale, without court action, necessitates strict compliance with statutory requirements as to notice, public sale, and accounting, and consequently the mortgagee may prefer to institute foreclosure proceedings. The property will then be sold by

order of the court. The proceeds will be applied to the satisfaction of the mortgage debt and all expenses of suit. The surplus, if any, belongs to the mortgagor. If the sale results in a deficit, the mortgagor remains personally liable therefor, and judgment against him may be entered accordingly.

CONDITIONAL SALE

In a contract of conditional sale title does not pass to the buyer until the happening of a specified condition — usually full payment of the price. Thus, in the typical instalment sale the buyer is entitled to immediate possession and use of the property and bears the risk of its loss or destruction, but the legal title remains in the seller until the buyer has paid or tendered the final instalment. The contract will not be deemed one of conditional sale unless it contains an express provision reserving title in the seller as security for the buyer's performance.

Recording. At common law a conditional vendor was protected without recording or filing the contract. The theory was that the vendee, having no title, could pass none to third persons. A minority of the states still follow the common law rule (thereby giving effect to a secret lien); most states, however, require the contract of conditional sale to be recorded or filed. As a penalty for noncompliance. the vendor cannot assert his title against bona fide purchasers from, or lien creditors of, the vendee, if such creditors acquire their lien without knowledge of the contract.

Conditional Sale of Goods for Resale. Where A sells goods on conditional sale to B (a dealer) with the express or implied understanding that B may resell in the ordinary course of business prior to the performance of the condition, B can pass good title (not subject to A's security interest) to C, a bona fide purchaser in the ordinary course of business. But A's reservation of title is effective (in most states) against lien creditors of B or others who take the goods in any transaction other than a sale in the ordinary course of business.

Election of Remedies by Vendor. On default in payment the vendor may sue for the entire unpaid balance due under the contract, or he may rescind and repossess the goods (if he can retake them without breach of the peace, otherwise by legal process) and may (by the majority rule at common law) retain all payments previously made. At least three statutory schemes to relieve the buyer from the supposed hardship of this rule have been adopted: (1) to require the return of part payments (minus proper deduction for use and damage) as a condition precedent to repossession; (2) to provide for compulsory resale; (3) to provide for resale at buyer's option. The Uniform Conditional Sales Act (adopted in ten states) enacts the second where more than half the price has been paid when default occurs. An election to rescind bars a recovery of any deficiency, but permits the seller to retain as his own any surplus that may be realized on resale. However, statutes in about half the states and the Uniform Conditional Sales Act impose liability on the buyer for such deficit, and require the seller to pay to the buyer the surplus (if any) over and above the unpaid balance of the purchase price plus all costs and expenses incurred by the seller in repossessing and reselling the goods.

TRUST RECEIPT

At common law the function of a trust receipt was to assist in the short-term financing of imports by some such transaction as the following: T (the importer), having no established bank credit, induces E (buyer-bank) to issue a letter of credit or otherwise undertake to accept or pay T's drafts or otherwise advance money in favor of S (the foreign seller) upon presentation to E of bills of lading to E's order or indorsed to E or in blank (so that legal title passes directly from S to E). E then delivers possession of the goods to T (to process and/or sell) taking from T a trust receipt whereby T undertakes to hold the title to the goods (and their proceeds) in trust for E until E is repaid. E is thus protected against T's creditors (lien or general) and trustee in bankruptcy and against persons dealing with

T (except as to purchasers, pledgees, or mortgagees of negotiable documents of title and — in states having a Factor's Act — purchasers, pledgees, or mortgagees from T, entrusted with possession with express or implied power to sell or pledge). But the courts declined to recognize, as a trust receipt at common law, a transaction where title was *first* acquired by T and then transferred to E, protecting the latter only if possession was taken by E (but E could hold C, buyer from T, if he had not paid or follow the proceeds if T misappropriated).

Uniform Trust Receipts Act. The Uniform Trust Receipts Act (already enacted in ten states) makes important amplifications of the concept so as to embrace not only (1) the foregoing transactions (where E is a new creditor, delivering to T goods, documents, or instruments — coming from S — in return for a security interest therein under a trust receipt) but also (2) a transaction where E is an old creditor delivering to his debtor (T) as trustee goods, documents, or instruments wherein E has already a security interest, wiping out the former security interest and taking in place thereof a trust receipt security interest in the same subject-matter; and (3) a transaction wherein E is a new creditor contracting for a security interest (by way of a trust receipt) in documents or instruments exhibited by T to E (before the transaction is completed) and retained by T. (T, a country bank, desires to borrow from E, a central reserve city bank, against notes receivable. E can acquire a security interest under a trust receipt by T's merely exhibiting the notes at the E bank. T is thus enabled to retain possession of its collateral for collection purposes, and relieved of the necessity of making numerous substitutions before maturity of the notes serving as collateral.) The security may thus come to E from S, or in substitution for existing security of E, or from T; but E cannot be either (a) the general owner of (or a dealer in) the goods, documents, or instruments (at the inception of the transaction) selling them to T on credit and retaining security by way of conditional sale or mortgage; or (b) a bailor or consignor plac-

ing goods with T for sale as agent. In Indiana, Illinois, California, and Connecticut the Act was adopted with the addition of certain provisions making the trust receipt device available in inventory financing — permitting one who lends on the borrower's stock in trade to acquire a security interest without filing a chattel mortgage. Such provisions would seem to violate the principles of the Uniform Act which seek to limit the trust receipt to the types of transactions therein defined and do not sanction its use as a substitute for either the chattel mortgage or conditional sale. Probably, where the consideration is antecedent or pre-existing, the act does not apply; and the old confusion will continue, some courts holding the transaction a conditional sale, some a mortgage, whether the security came from T or from S, while still others sustain the transaction only if it is tripartite.

Possession of goods, documents, or instruments must either remain in T or pass to T, as a result of the trust receipt transaction, to be held or obtained: (1) to enable T to sell or exchange them, or (2) to process goods (entrusted or represented by documents entrusted) preliminary to sale by T, or (3) for T to deliver the instruments to his principal, or to a depositary or registrar, or to use them for presentment, collection, or renewal. T's attempted waiver of his equities is for the most part invalid.

Protection against Creditors and Third Parties. E is protected (in his security interest) against T's creditors for thirty days without filing, but after thirty days his trust receipt is invalid against C (lien creditor of T) who has acquired a right *in rem* without actual notice thereof (if it was not filed) and prior to E's taking possession. Filing or taking possession by E validates the trust receipt as to all creditors of T thereafter except that those having a lien for processing, transporting, or warehousing the goods have priority over the rights of E irrespective of the date of filing. As to persons dealing with T: (1) if a negotiable instrument or document (original or substituted) is negotiated to C, a bona fide purchaser (and filing is not constructive notice) his title is (as at common law) superior to E's; (2) if C

is a purchaser in the ordinary course of business (which includes a purchaser on credit) of nonnegotiable instruments or documents, or of goods, from T, his rights are superior to those of E if T had unlimited power of sale (irrespective of filing) or if C had no actual knowledge of limitations thereon (putting or keeping the goods in T's show room confers power of sale); (3) if C purchased not in the ordinary course of business (or took by chattel mortgage, pledge, or sale in bulk), his rights are subordinate to those of E (irrespective of filing) unless (a) as pledgee or mortgagee he gave *new value* [2] to T within thirty days after the giving of the trust receipt and got possession of the goods, documents, or instruments before the trust receipt was filed, or (b) he gave *value* after the thirty day period and got possession before the trust receipt was filed. Filing under the act refers to a statement (of intent to do business under the trust receipt plan) signed by E and T and filed with the secretary of state, effective for one year.

Entruster's Remedies on Trustee's Default. On default by T, E may take possession (without breach of the peace) of the property described in the trust receipt, and may sell it on five days' written notice, applying the proceeds to the debt, T being liable for any deficit and entitled to receive any surplus. E has power to convey a good title to C, a bona fide purchaser (even though the sale is a conversion). As to property no longer in T's hands, E is entitled to the debt arising on its sale by T (subject to equities accruing to C before he had actual notice of the trust receipt). If the trustee has collected such debt or sold for cash, the act attempts to give the entruster a preference as to moneys received by the trustee within ten days of receivership or bankruptcy, even though the entruster is unable to

---

2 "*New value*" includes new advances or loans made, or new obligation incurred, or the release or surrender of a valid and existing security interest, or the release of a claim to proceeds; but "new value" shall not be construed to include extensions or renewals of existing obligations of the trustee, nor obligations substituted for such existing obligations.

"*Value*" means any consideration sufficient to support a simple contract. An antecedent or pre-existing claim, whether for money or not, and whether against the transferor or against another person, constitutes value where goods, documents, or instruments are taken either in satisfaction thereof or as security therefor.

trace or identify such moneys. However, this preference would seem to be of no avail in bankruptcy, inasmuch as the Bankruptcy Act does not recognize priorities created by state statutes, with the exception of a landlord's claim for rent.

Defective Pledge. The Act also covers cases of attempted pledge (without delivery of possession) by T to E giving new value, protecting E for ten days from creditors of T but subject to rights of lien creditors thereafter without notice; if E gave no new value his rights are inferior to those of lien creditors of T without notice or bona fide purchasers from T. It also upholds as against all creditors the validity of a pledge, although the property is redelivered (for not more than ten days) for a limited purpose.

Chapter XLVI

MORTGAGES ON REAL PROPERTY

LIEN AND TITLE THEORIES

A mortgage on real property is a security interest in real property given by a mortgagor to a mortgagee to secure a debt or other obligation. The common law emphasized the element of *conveyance* (of an interest capable of passing by purchase or by descent, including — in equity — property to be acquired by the mortgagor and even an option) and saw a mortgage as a transfer (of a qualified or conditional estate) defeasible upon strict performance but absolute upon default. Equity on the other hand recognized *security* (for a valid debt — not necessarily entailing personal liability — of the grantor) as the dominant feature of a transfer of the legal title by way of a mortgage and in the course of time many courts adopted this view at law. The common law gave the mortgagee the right to immediate possession and to the rents and profits. If the mortgagor was but a day late in paying the debt he forfeited his entire interest in the property. Equity soon relieved against such forfeitures, creating for the protection of the mortgagor a new right — the equity of redemption, permitting a mortgagor in default to redeem his land by paying the amount due with interest and expenses. The courts are divided as to the nature of a mortgage; most of them hold it to be merely a lien, while others retain the theory that it passes the legal title, but virtually all of the unfair common law incidents that flowed from the title theory have been eliminated by statute or decision. Thus, in a title theory state, the mortgagee has the right to possession of the mortgaged premises (unless the mortgage contains a provision to the contrary) after execution and delivery of the mortgage and even be-

fore maturity of the debt, but he must account to the mortgagor for any rents or profits received from the property. In the lien theory states, the mortgagor has the right to remain in possession. He is usually required to insure the property for the protection of the mortgagee, who (in case of loss) has an equitable lien on the proceeds to the extent of his interest. Under either the lien or the title theory, the mortgagee can enjoin any use of the property which impairs its value to the point of rendering its security of doubtful sufficiency. Thus, a mortgagor in possession has no right (unless with the express or implied consent of the mortgagee) to remove buildings, cut timber, mine ore, pump oil, or extract coal, even though the mortgagor is regarded (under the lien theory) as the owner of the land. Technically, such use of the land constitutes "waste," and in some instances the mortgagee may even enjoin an alteration which enhances the value of the mortgaged premises (ameliorating waste).

In most states a mortgage to secure unlimited future advances (or future indorsements) is good (even though the mortgagee is not bound to make them) but some states insist upon a difference in this respect between obligatory and discretionary advances.

Actual payment before, at, or after maturity discharges the mortgage "ipso facto et eo instanti," and the mortgagee must give a release or satisfaction to the mortgagor, by the recording of which the record title is cleared. If the satisfaction is not recorded, the mortgage constitutes a cloud (apparent encumbrance) on the title, and can be removed only by court action.

Even under the title theory a tender on the law day (date of maturity of the debt secured by the mortgage) of the amount due (though unaccepted) discharges the mortgage and (without reconveyance) is generally held to revest the title in the mortgagor, but a tender after the due date does not at common law (where the mortgagee's estate became absolute in case of nonperformance on the law day) terminate the mortgagee's security interest; the weight of au-

thority is said to be otherwise under the lien theory, where there is tender after maturity but before foreclosure. By statute in a number of states a mortgagee (having received payment of the mortgage debt) must enter satisfaction thereof on the mortgage record (or execute a release thereof); otherwise he will be liable to a penalty as well as for damages. Unless expressly agreed, the mortgagor has no right to anticipate payment, and a tender before the due date is not a legal tender and does not extinguish the mortgage; the mortgagee may prefer to have his money invested in the mortgage until the maturity date. The mortgagor cannot (in the absence of waiver) exercise his right of redemption before maturity (receipt, before maturity, of part of the debt is not waiver of the right to hold the rest of the investment until maturity); but if the mortgagee exercises his legal right to take possession, it has been held that the mortgagor has an immediate right to redeem.

FORM

In form the mortgage is still a conveyance of the legal title and must be executed with the same formalities prescribed for a deed. The obligation which it secures is usually evidenced by a separate writing (a bond or a promissory note.)

1. **Deed of Trust.** A corporation may issue to X, as trustee, a deed of trust on corporate property, to secure a bond issue. The deed of trust is generally held to be a mortgage securing each bondholder. There may be thousands of bondholders (all represented by X) and the single deed of trust eliminates the necessity for giving a separate mortgage to each bondholder.

2. **Deed Intended as a Mortgage.** A may deliver to B a deed absolute in form, but intended merely to secure some obligation. Parol evidence is admissible to establish such intention, and if the evidence is clear the deed will be given the effect of a mortgage, and A will be permitted to redeem. Similarly, a deed which confers on the grantor the right to repurchase the land may be treated as a mortgage.

WHAT INTERESTS ARE MORTGAGEABLE

Any present interest in real property (legal or equitable) can be mortgaged (a fee, a life estate, a leasehold interest, a dower interest, the interest of a mortgagor or mortgagee or

of vendor or vendee under a contract for the sale of land). If the real estate is improved, either the land or the improvement may be separately mortgaged, or, as is more usual, the mortgage may include both.

Mortgage on After-acquired Property. After-acquired property is merely an expression for the possibility that one may *in the future* acquire certain property. This mere possibility cannot be the subject of a valid mortgage at law, but an after-acquired property clause in a mortgage will, nevertheless, create an equitable lien or charge on such property (specifically included) as of the time when it is acquired by the mortgagor. While it is in general true that at law one cannot effectively mortgage property to be acquired in the future, yet a mortgage of land attaches thereto as changed and improved by natural or artificial accession, substitution, or accretion (buildings erected on mortgaged lands, machinery or equipment so annexed to mortgaged buildings as to become part thereof). As an instance of natural accession, one may cite a crop mortgage — even though given at a time when the crop has not yet been planted. The crop is the increase of the land and is "potentially" in the possession of the landowner. (Some states hold such mortgages invalid as against attaching creditors of the mortgagor, on the ground that annual crops [*fructus industriales*] do not have even a potential existence before planting, in which respect they differ from *fructus naturales*, not requiring annual cultivation.)

Mortgage on Equity of Redemption. The interest of a mortgagor is his equity of redemption. The mortgage of such interest is known as a second mortgage. (A owns property valued at $25,000. He gives to B a first mortgage in the amount of $10,000. A's equity in the property is now $15,000. A gives to C a second mortgage in the amount of $5,000. A's equity now is $10,000. Theoretically A may give any number of successive mortgages on his diminishing equity, but in practice one rarely finds property encumbered by more than two mortgages.)

thority is said to be otherwise under the lien theory, where there is tender after maturity but before foreclosure. By statute in a number of states a mortgagee (having received payment of the mortgage debt) must enter satisfaction thereof on the mortgage record (or execute a release thereof); otherwise he will be liable to a penalty as well as for damages. Unless expressly agreed, the mortgagor has no right to anticipate payment, and a tender before the due date is not a legal tender and does not extinguish the mortgage; the mortgagee may prefer to have his money invested in the mortgage until the maturity date. The mortgagor cannot (in the absence of waiver) exercise his right of redemption before maturity (receipt, before maturity, of part of the debt is not waiver of the right to hold the rest of the investment until maturity); but if the mortgagee exercises his legal right to take possession, it has been held that the mortgagor has an immediate right to redeem.

FORM

In form the mortgage is still a conveyance of the legal title and must be executed with the same formalities prescribed for a deed. The obligation which it secures is usually evidenced by a separate writing (a bond or a promissory note.)

1. **Deed of Trust.** A corporation may issue to X, as trustee, a deed of trust on corporate property, to secure a bond issue. The deed of trust is generally held to be a mortgage securing each bondholder. There may be thousands of bondholders (all represented by X) and the single deed of trust eliminates the necessity for giving a separate mortgage to each bondholder.

2. **Deed Intended as a Mortgage.** A may deliver to B a deed absolute in form, but intended merely to secure some obligation. Parol evidence is admissible to establish such intention, and if the evidence is clear the deed will be given the effect of a mortgage, and A will be permitted to redeem. Similarly, a deed which confers on the grantor the right to repurchase the land may be treated as a mortgage.

WHAT INTERESTS ARE MORTGAGEABLE

Any present interest in real property (legal or equitable) can be mortgaged (a fee, a life estate, a leasehold interest, a dower interest, the interest of a mortgagor or mortgagee or

of vendor or vendee under a contract for the sale of land). If the real estate is improved, either the land or the improvement may be separately mortgaged, or, as is more usual, the mortgage may include both.

Mortgage on After-acquired Property. After-acquired property is merely an expression for the possibility that one may *in the future* acquire certain property. This mere possibility cannot be the subject of a valid mortgage at law, but an after-acquired property clause in a mortgage will, nevertheless, create an equitable lien or charge on such property (specifically included) as of the time when it is acquired by the mortgagor. While it is in general true that at law one cannot effectively mortgage property to be acquired in the future, yet a mortgage of land attaches thereto as changed and improved by natural or artificial accession, substitution, or accretion (buildings erected on mortgaged lands, machinery or equipment so annexed to mortgaged buildings as to become part thereof). As an instance of natural accession, one may cite a crop mortgage — even though given at a time when the crop has not yet been planted. The crop is the increase of the land and is "potentially" in the possession of the landowner. (Some states hold such mortgages invalid as against attaching creditors of the mortgagor, on the ground that annual crops [*fructus industriales*] do not have even a potential existence before planting, in which respect they differ from *fructus naturales,* not requiring annual cultivation.)

Mortgage on Equity of Redemption. The interest of a mortgagor is his equity of redemption. The mortgage of such interest is known as a second mortgage. (A owns property valued at $25,000. He gives to B a first mortgage in the amount of $10,000. A's equity in the property is now $15,000. A gives to C a second mortgage in the amount of $5,000. A's equity now is $10,000. Theoretically A may give any number of successive mortgages on his diminishing equity, but in practice one rarely finds property encumbered by more than two mortgages.)

PURCHASE MONEY MORTGAGE

A purchase money mortgage is given (contemporaneously with the acquisition of the legal title or as part of the same continuous transaction) to secure all or part of the purchase price of land. If A delivers such mortgage to B, B's right is superior to all claims or liens arising through A (though prior in time), including the dower interest of A's wife, the liens of A's judgment creditors, and any other prior or subsequent mortgage of A, on the theory that the execution of the deed and mortgage are simultaneous acts, so that no claim arising through A can attach before the purchase money mortgage (which is deemed merely to continue the pre-existing right of the vendor).

RECORDING MORTGAGES

A mortgage given by A to B is valid between the immediate parties without recording. But if A subsequently conveys the property to X, a bona fide purchaser for present value and without notice of the unrecorded mortgage held by B, X would take the property free and clear of B's right. Similarly if A gives a mortgage to X to secure a present advance, X having no knowledge of B's unrecorded mortgage, B's right will be subordinate to that created by X's mortgage. Hence, B must record his mortgage in order to preserve its priority with respect to subsequent (junior) encumbrancers or bona fide purchasers.

ASSIGNMENT OF MORTGAGE DEBT

A transfer by A to B of the mortgage debt, if evidenced by a nonnegotiable note or bond, puts B in the position of an assignee subject to all defenses available against A (the assignor). If the debt is evidenced by a negotiable note or bond transferred to B by negotiation, B may be in the position of a holder in due course and take free of personal defenses available against A. On default (whether or not the note or bond is negotiable in form), B (the transferee) can enforce the mortgage security. If A transfers the debt to B and the mortgage to X, X holds the security interest in

trust for B ("security follows the debt"). An assignment should be recorded for the same reason that a mortgage should be recorded — to protect the assignee against subsequent bona fide purchasers. Recording, however, is not notice to the mortgagor. The assignee must give him actual notice; otherwise the mortgagor will be protected with respect to any payments he may make to the mortgagee.

SALE OF MORTGAGED REAL ESTATE

If A (mortgagor) sells to B property on which C holds a mortgage, this does not exonerate A (even though B personally assumes the debt) unless: (1) there is a novation (whereby C accepts the personal liability of B in place of that of A), or (2) C releases B, or (3) C with knowledge of the facts makes a binding agreement with B for an extension of time without A's consent or without reserving his rights as to A. (A is deemed to be injured by such extension agreement, as it precludes payment by A at maturity with the consequent right in A to be subrogated to C's position.) B may take title:

1. **Subject to C's mortgage.** If C's mortgage secures a debt of $5,000 and the property is valued at $10,000, and B pays $5,000 and takes a deed "subject to" C's mortgage, this does not *per se* impose on B a personal obligation to pay C. If C forecloses his mortgage, B may permit the property to be sold, and he will in no event be liable for any deficiency if the property brings less than the amount due under the mortgage. In this situation, after the transfer to B, A is a surety for the mortgage debt, but B is not the principal debtor: the land itself stands in a position analogous to that of a principal debtor.

2. **Assumption of Mortgage.** B pays $5,000 for the property and assumes payment of C's mortgage (by manifestation of such intent through deducting the amount of the mortgage debt from the purchase price, acceptance of a deed containing such recital, or otherwise). B here becomes the principal debtor and A the surety after the transfer, and, in jurisdictions recognizing this change in relationship, A is released if C grants B an extension without A's consent.

FORECLOSURE

Foreclosure, by which the mortgaged property is applied to the satisfaction of the debt, may be either by judicial proceedings (followed by judicial sale) or (in most states), without recourse to the courts, pursuant to irrevocable power

of sale (coupled with an interest) contained in the mortgage (usually after public notice, and sometimes by a public official or confirmed by the court, as required by the applicable statute). The second method has been deemed inferior, and relatively inconclusive, as open to attack for defect of notice or otherwise. If foreclosure is by the former method, the land is usually sold under court order, the proceeds being applied first to the mortgage debt, and next to the satisfaction of claims of junior lienors in the order of their priority; and finally the surplus, if any, is paid to the mortgagor. If the proceeds of sale are insufficient to satisfy the mortgage debt, most states authorize the entry of a deficiency judgment against the mortgagor for the deficit.

REDEMPTION

Assume that A is the owner of certain real estate. As a general rule anyone with an interest in the land and in privity with the mortgagor (A) — including an heir, junior mortgagee, or judgment creditor of A, or a tenant from, or cotenant with, him—is entitled to redeem. Thus assume A gives a first mortgage to B, and later a second mortgage to C. D then files notice of mechanics' lien against the property. If B's mortgage falls due and A defaults in payment, A, C, and D (or anyone deriving an interest in the mortgaged premises through A) have the right to redeem their respective interests by payment of the entire debt secured by B's mortgage with interest and such other sums (including court costs) as B may be entitled to under the provisions of his mortgage.

The right to redeem may be exercised upon strict compliance with the applicable statutes (or with the condition in the case of foreclosure by action) at any time after default and before sale on foreclosure (except where statutes bar redemption after a fixed period). Many states permit redemption within a limited time (even after sale on foreclosure) by payment to the court officer who sold the property of an amount equal to the sum bid for the property plus interest and costs.

If A (the mortgagor) fails to pay taxes or assessments or to defend his title when sued, B (the mortgagee) may make such payments and take such steps as may be necessary to maintain the integrity of the security, and A is under a duty to reimburse B for any sums reasonably expended to that end.

The right to redeem cannot be waived by agreement made contemporaneously with, or as a part of, the mortgage transaction, as the courts will not enforce penalties or forfeitures.

Chapter XLVII

GUARANTY AND SURETYSHIP

The risks involved in many business transactions turn upon performance by B of some duty owed to A (the duty to pay a debt, to perform a building contract, to be honest in handling cash and securities entrusted to B's custody). A can often minimize such risks by obtaining from C a promise to answer for B's performance. It is essential to the relation of guaranty or suretyship that at least three persons be involved, and that C's promise (in form or in substance) be a promise to answer for performance by B. Common examples of the suretyship relation are: retiring partner, continuing partner, and firm creditor; grantee who assumes an existing mortgage, mortgagor, and mortgagee. In the following discussion C designates the guarantor or surety, B the principal debtor or obligor, and A the creditor or obligee.

SURETY AND GUARANTOR DISTINGUISHED

Modern usage tends to the view that the word "surety" includes everyone (C) bound on an obligation which, as between himself and another person (B), also bound to the obligee (A) for the same performance, should be discharged by B. In this general sense, indorsers and guarantors are sureties. More narrowly, a "surety" is one making to A an "original," "primary," "absolute," or "unconditional" promise to pay the debt, whereas a guarantor is one making to A a "collateral" or "secondary" engagement to answer for the debt if the principal debtor (B) fails to pay. The essence of the suretyship relation is that *as between B and C,* the ultimate liability to pay the debt rests on B; and all cases where that relation exists may be described, for clarity, by

the single term "suretyship." The surety may annex to his promise any (lawful) contractual condition (C may promise to pay A: [1] if B fails to pay, or [2] if A, having made diligent efforts, is unable to collect from B, or [3] if B is or becomes insolvent). A's right is in every case determined accordingly by C's undertaking as interpreted in the light of the canons and standards applicable to the interpretation of contracts in general. An indorser is in this sense a surety, whose undertaking is subject to conditions (particularly as to diligence) imposed by the law of negotiable instruments.

Contracts of guaranty or suretyship are subject to the requirements of contracts in general (agreement, consideration, competency of parties, form, legality) and may or may not fall within the Statute of Frauds, depending on circumstances previously discussed (Chapter V). In the absence of express agreement the surety or guarantor enjoys certain rights peculiarly incident to the guaranty or suretyship relation, and these will now be considered. In what follows, C will designate either a guarantor or a surety.

SURETY'S RIGHTS: INDEMNIFICATION

If C, being legally obligated to do so, pays all or part of B's debt, B must reimburse C to the extent of the actual payment made by C, not including, however, costs (unnecessarily incurred in defending against asserted liability) or attorneys' fees which C has been compelled to pay either to his (C's) attorney or to A's attorney, since the payment of such fees could have been avoided by C's making prompt settlement on B's default.

SURETY'S RIGHTS: CONTRIBUTION

C may have one or more cosureties (D, E, F). If C makes payment he can compel D, E, and F to contribute their respective shares (equal unless otherwise agreed). If F is insolvent or outside the jurisdiction, then (in the absence of contrary agreement) D and E each must (in equity) contribute one-third (not one-fourth) of the payment made by C. If C has made only a partial payment on B's debt, C

cannot sue D, E, or F unless such partial payment amounts to more than C's pro rata share. If A grants an extension of time to D, the non-assenting cosureties C, E, and F are not discharged absolutely but only to the extent that D would otherwise be liable to contribute; viz., one-fourth of the obligation (D's share). A fiduciary relation subsists between C, D, E, F. Hence, if collateral (procured subsequently to the execution of the primary obligation) is held by any one of them, the others have a right to share in any proceeds that may be derived therefrom.

SURETY'S RIGHTS: SUBROGATION

On payment of B's debt, C acquires A's claim and may proceed to enforce such claim by suit just as A might have done. C is likewise entitled to the benefit of any security deposited with A or any lien against B's property in favor of A, and may exercise such power of sale or foreclosure with respect thereto as A might have exercised, notwithstanding the fact that C had no knowledge of such security at the time he became surety, or that A did not acquire such security until after C became surety. If, however, C has paid only part of B's debt to A, then his right of subrogation with respect to security in A's possession extends only to the excess over what is necessary to protect A on the balance due him. (If B deposited securities with C to be applied to B's debt, C must, of course, make such application.)

If A has collateral security for a number of claims, C's right of subrogation does not arise unless all such claims have been paid. The right of subrogation, moreover, applies only with respect to property deposited with A by B as security — if some third person (X) has also pledged property with A to secure B's debt, C has no equity in such property.

A also has a right of subrogation to the extent of his claim with respect to securities deposited with C by B. If C returns the securities to B, A can impress upon them a lien in his favor provided the rights of innocent third parties have not intervened. If, however, the securities were de-

posited with C by some third person (X), A has no equity in them: since the securities do not belong to B, they cannot be said to form the subject matter of a trust created by B for the payment of his debt to A.

SURETY'S RIGHTS: EXONERATION

On default by B, C may be unable to pay save by forced sale of his (C's) assets. In that event his right of indemnification, contribution, or subrogation will not protect him against loss. Accordingly, the law permits C (on B's default) to bring action at once against B and the cosureties D, E, F to compel payment by B to A or contribution by D, E, F to himself (C). Such action by C, before making any payment to A, is a legal incident of C's right to exoneration.

THE SURETY'S DEFENSES

1. **Surety's Grievance against Principal Debtor.** Facts giving C a cause of action against B may not be used by way of defense against A (the creditor). C may have been induced to become a surety through B's misrepresentations; C may have had an understanding with B that C was not to become liable on his undertaking unless X also became bound as a surety; B may have defaulted in payment of premium due C in consideration of C's undertaking to guarantee B's performance—none of these circumstances is matter of defense in an action by A against C.

2. **Defenses of Principal Debtor Available to Surety.** In general, any defense (lack or failure of consideration, illegality) available to B (the principal debtor) may also be interposed by C (the surety), with the exception of contractual incapacity (including *ultra vires*) or that the principal obligation is unenforceable (as within the statute of Frauds)—although where B, an infant, disaffirms the contract and returns the consideration to A, many courts hold that C is not liable to A. Where B contracted under duress, some courts refuse to allow the defense in favor of C unless he was ignorant of the fact of duress. The courts are also in conflict as to whether, where A's claim against B is outlawed, C may interpose the defense of the Statute of Limitations. If B has been induced to contract by A's fraud, B has an election between rescission and damages. Hence, where B has repudiated, C may defend on the ground of fraud; otherwise some courts hold that he may not avail himself of the defense, as B has the right to decide what use he desires to make of the facts constituting fraud.

3. **Defenses Based on Fiduciary Relationship.** The suretyship relation is fiduciary in its nature; hence A must impart to C any information pertinent to the risk C assumes. If A knows that his employee B, has been guilty of past defalcations, A must inform C as to such fact; otherwise if C bonds B and sub-

sequently learns of B's past dishonesty, C can rescind and avoid any liability. Moreover, if B's past record for honesty is good, A must discharge him after the first offense; otherwise A cannot hold C liable for subsequent defalcations by B unless C consents to A's giving B another chance.

4. **Extension Agreements.** If A, without C's consent, binds himself to extend the time for B's performance, C is discharged, whether or not C's chance of indemnification has in fact been impaired by such extension. To effect such discharge, however, mere voluntary indulgence or forbearance by A is not sufficient: there must be a binding extension agreement. Notice to C of such agreement does not take the place of his consent. However, even though C does not consent thereto, the extension agreement does not discharge C if:

(a) A reserves his rights against C (thereby leaving C free to pay B's debt on the original maturity date, and proceed at once against B for reimbursement); or

(b) Ample securities have been deposited with C (in which event C could not possibly be damaged by the extension); or

(c) C is a paid surety (has received compensation for the risk he assumes). In such case an extension will discharge C only if he can prove damage—that is, prove that B's financial condition at the extended maturity date was worse than at the original maturity date of the debt or obligation; or

(d) The debt arose under a continuing guaranty. (C guaranteed payment up to $5,000 of goods sold by A to B. A extends a past due item of $2,000. C is not released provided other items in addition to the $2,000 item do not exceed $5,000.)

5. **Discharge of Principal Debtor.** If A releases B, without reserving his (A's) rights against C, C is released, unless (as in the case of an extension to which C does not consent) C is protected by the deposit of ample securities. Similarly, any material change in the terms of the contract between A and B discharges C unless he consents thereto.

6. **Release of Collateral.** If A releases to B collateral pledged with A to secure the debt, C is discharged to the extent of the value of the released collateral.

7. **Payment or Tender of Payment.** Payment or tender of payment by B discharges C. Receipt by A of B's promissory note or check does not constitute payment and hence does not release C until such instrument has been paid. If B owes A other debts which are unsecured, A would naturally apply a payment by B to them rather than to the debt for which C is surety. In the absence of a direction by B as to how the payment is to be applied, A would be at liberty to make any application he pleased and C could not object thereto. C may, however, require B to agree to direct application of payments to the secured claim.

8. **Set-off and Counterclaim.** If C has a claim against A he may set it off when sued by A on B's default.

CONTINUING GUARANTY

If C writes A, "Let B have what leather he wants, and charge same to B. I will see that you have your pay in a

reasonable length of time," the guaranty is limited to a single purchase or transaction, on the ground that "it is not reasonable to presume any man of ordinary prudence would become surety for another without limitation as to time or amount." C's undertaking would be construed to be a continuing guarantee if C set a limit on either the time or the amount. If C limits the time but not the amount, C's guarantee imports liability to a reasonable amount. By giving notice to A, C can at any time revoke a continuing guarantee, thereby terminating his liability for B's obligations incurred after receipt by A of notice of revocation. Most courts hold that C's death or insanity automatically revokes his continuing guaranty without notice to A.

Part IX: Bankruptcy

Chapter XLVIII

BANKRUPTCY

FEDERAL JURISDICTION OVER BANKRUPTCY

The Constitution confers upon Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States." The latest comprehensive revision of the bankruptcy law of 1898 was the Chandler Act (effective September 22, 1938). All bankruptcy legislation is informed by a double purpose: to give an honest debtor the opportunity to rehabilitate himself, and, in the event of liquidation, to make a fair distribution of his assets among his creditors. Less obvious, but perhaps more important, is the regulatory and unifying influence of bankruptcy law on credit transactions and business usage throughout the country.

VOLUNTARY OR INVOLUNTARY PROCEEDINGS

Bankruptcy is either voluntary or involuntary, depending upon whether the proceeding is initiated by the debtor's filing a voluntary petition in a United States District Court, or by his creditors' filing an involuntary petition in that court. With reference to ends sought to be accomplished, available procedures may be classified as follows:

Voluntary Proceedings by Corporations (except building and loan associations, municipal, railroad, insurance, or banking corporations):

1. **"Strict" Bankruptcy:** liquidation of assets, ratable distribution to creditors, and discharge of bankrupt.

2. **Arrangement:** agreement requires consent of majority in number and amount of creditors and approval by the court. (Claims for $50 or less are not counted in computing the *number* of creditors: so that holders of small claims cannot control the administration of the estate.) The arrangement affects only un-

secured debts. Consideration for arrangement may be debtor's stock or other securities, or extension of time may be granted without any consideration, the business meanwhile being operated by a receiver, trustee, or by the debtor-in-possession. Unsecured claims may be classified and small claims given priority.

3. **Reorganization:** if adequate relief cannot be obtained under Arrangement Proceedings, the corporation may be permitted to reorganize. Reorganization usually involves a scaling down of the capital and debt structure, including secured obligations. Where indebtedness exceeds $3,000,000 the plan of reorganization must be submitted to the Securities and Exchange Commission for examination, and the commission may intervene as a party in any reorganization proceeding. The plan of reorganization must be approved by "creditors holding two thirds in amount of the claims filed and allowed of each class, and, if the debtor has not been found to be insolvent, by or on behalf of stockholders holding the majority of stock . . . of each class" (Sec. 179).

Voluntary Proceedings by Individuals:

1. **Strict Bankruptcy:** petitioner may be solvent or insolvent.

2. **Arrangement Procedure.**

3. **Real Property Arrangements:** provide for settlement or extension of debts secured by real property.

4. **Wage Earners' Plans:** provide for payment of debts (secured and unsecured) out of future earnings. Unsecured creditors must approve plan by majority in number and amount of claims. Claims of secured creditors who do not assent to the plan are not affected.

Involuntary Proceedings against Corporations (other than a building and loan association, or a municipal, railroad, insurance, or banking corporation):

1. **Strict Bankruptcy:** petition for adjudication may be filed by three or more creditors whose unsecured claims in the aggregate amount to $500 or over but debtor cannot be adjudicated a bankrupt unless his debts amount to $1,000 or over. Petition may be filed within four months after the commission of an act of bankruptcy.

2. **Reorganization:** petition may be filed by three or more creditors whose claims in the aggregate amount to $5,000 or over, or by an indenture trustee. Petition must state that the corporation is insolvent (liabilities exceed assets) or that it is unable to meet its debts as they mature; facts showing that adequate relief cannot be obtained under the Arrangement Procedure; and

"(1) that the corporation was adjudged a bankrupt in a pending proceeding in bankruptcy; or

"(2) that a receiver or trustee has been appointed for or has taken charge of all or the greater portion of the property of the corporation in a pending equity proceeding; or

"(3) that an indenture trustee or a mortgage under a mortgage is, by reason of a default, in possession of all or the greater portion of the property of the corporation; or

"(4) that a proceeding to foreclose a mortgage or to enforce a lien against all or the greater portion of the property of the corporation is pending; or

"(5) that the corporation has committed an act of bankruptcy within four months prior to the filing of the petition."

Involuntary Proceedings against Individuals.

Strict Bankruptcy. Any person owing debts amounting to $1,000 or more (except a wage earner whose compensation does not exceed $1,500 a year, or a farmer) may be adjudicated an involuntary bankrupt. Petition may be filed (within four months of the commission of an act of bankruptcy) by three or more creditors whose unsecured claims in the aggregate amount to $500 or over. Where there are less than twelve creditors the petition may be filed by one creditor whose unsecured claims in the aggregate amount to $500 or over.

ACTS OF BANKRUPTCY

Involuntary petitions for adjudication ("strict" bankruptcy) must, and involuntary petitions for corporate reorganization may, be based on the commission of an act of bankruptcy within four months before the filing of the petition. Six acts of bankruptcy are defined by the statute:

1. **Fraudulent Conveyance:** transfer, removal, or secretion of assets by the debtor (whether solvent or insolvent at the time) with intent to hinder, delay, or defraud creditors. Solvency of the debtor at the time the petition is filed is a complete defense to any proceeding based on this first act of bankruptcy.

2. **Preference:** transfer by the debtor, *while insolvent,* of "any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors."

3. **Preference by Judicial Liens** occurs where a person has "suffered or permitted, *while insolvent,* any creditor to obtain a lien upon any of his property through legal proceedings and not having vacated or discharged such lien within thirty days from the date thereof or at least five days before the date set for any sale or other disposition of such property." In determining whether this act has been committed within four months before the filing of a petition, the starting point is not the date of the lien but the expiration of the thirty day period or the fifth day before the date set for the sale of such property.

4. **General Assignment** for the Benefit of Creditors. (Insolvency at the time of such assignment is not a necessary element of this 4th act of bankruptcy.)

5. **Appointment of Receiver or Trustee** (while debtor is *insolvent* or unable to pay his debts as they mature).

6. **Written Admission** of Inability to Pay Debts and Willingness to be adjudged a bankrupt (insolvency — excess of liabilities over assets — is not a necessary element of this 6th act of bankruptcy).

In connection with the 2nd, 3rd, or 5th act of bankruptcy, the solvency of the debtor at the time of filing the petition, or his inability to pay his debts as they mature, may be put in issue by the debtor. In no case is mere insolvency sufficient to ground an involuntary petition against the debtor. With reference to acts 1, 2, and 4, in order to determine whether the act of bankruptcy has been committed within four months before the filing of the petition, one must take as a starting point the date when "the transfer became so far perfected (e.g., by recording) that no bona fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein; but if such transfer is not perfected prior to the filing of the petition in bankruptcy . . . it shall be deemed to have been immediately made before the filing of such petition."

ADJUDICATION

The debtor may file an answer to an involuntary petition. The judge determines the issues and either dismisses the petition or adjudicates the debtor a bankrupt. (The debtor may have a jury trial on the issue of insolvency or any act of bankruptcy alleged to have been committed by filing a request therefor with his answer.)

PROCEEDINGS AFTER ADJUDICATION

Proceedings after adjudication may be conducted by the Referee, an officer appointed by the District Court and now required to be a member of the bar of that district in good standing. Within five days after adjudication the bankrupt must file his schedules (in voluntary bankruptcy schedules must accompany the petition) listing all creditors and the amount of their claims, and the bankrupt's claim for exemption.

FIRST MEETING OF CREDITORS

The Referee calls and presides over the first meeting of creditors held after adjudication. The bankrupt is required

to be present, and to submit to an examination concerning his property. (A bankrupt may be required to file a cost inventory, as of the date of bankruptcy; and in any proceeding to compel a bankrupt to turn over property or to account for its disposition, "if his books, records, and accounts shall fail to disclose the cost to him of such property sold by him during any period under consideration, it shall be presumed, until the contrary appear, that such property was sold at a price not less than the cost thereof to him.") The creditors at the first meeting elect the trustee, who must receive the votes of a majority in number of the creditors (*exclusive* of creditors whose claims are for $50 or less) and the votes of creditors holding a majority in amount of all claims (*including* claims of $50 or less). Secured creditors may vote only to the extent that their claims exceed the value of securities or priorities enjoyed by them. Relationship within the third degree of consanguinity as interpreted at common law, or affinity to the bankrupt (bankrupt's spouse, the stockholders, officers, and directors of a bankrupt corporation) may disqualify a creditor for voting for the trustee.

TRUSTEE

The duty to liquidate assets and make distribution to the creditors rests on the trustee. Pending his election by the creditors, the court may appoint a Receiver, who has temporary custody of assets; but upon election and qualification, the trustee acquires the title of the bankrupt (as of the date the petition in bankruptcy was filed) to all of the bankrupt's property, except allowable exemptions which the trustee must set aside. The trustee enjoys the status of a lien creditor with respect to the bankrupt's property, and this may place him in a position superior to that of the bankrupt (as where bankrupt is in possession of goods under an unrecorded conditional sales contract, or as mortgagor under an unrecorded chattel mortgage). Within sixty days after the bankrupt's adjudication the trustee may elect to assume or reject executory contracts of the bankrupt (leases, contracts

for future delivery of merchandise). If no election is made within sixty days, such contracts are deemed rejected as a matter of law.

DEBTS WHICH HAVE PRIORITY

Before creditors are entitled to receive any dividends the following must be paid in full and in the order named:

1. Costs of administration, including expenses incurred by creditors in recovering assets for the benefit of the estate, counsel fees of attorneys representing the petitioning creditors, the bankrupt, receiver, and trustee.

2. Wages, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt.

3. Reasonable costs and expenses incurred by creditors who, by their objections, have prevented the confirmation of an arrangement or wage-earner plan, or the discharge of the bankrupt, or who have adduced evidence resulting in the conviction of any person of an offense under the Bankruptcy Act.

4. Taxes due and owing to the United States, or to any state or any subdivision thereof, provided the tax does not exceed the bankrupt's interest in the property against which it is assessed.

5. Debts entitled to priority under the laws of the United States, but not under state laws (in a bankruptcy proceeding in New York a claim for premiums for workmen's compensation insurance is not entitled to priority: the New York statute purporting to confer priority on such claim is of no effect). However, if a landlord's claim for rent is entitled to priority under state law, such claim has priority in bankruptcy, but "such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy."

VOIDABLE PREFERENCE

"Preference" as an act of bankruptcy does not mean the same thing as "voidable preference," a transfer of property by the bankrupt which may be set aside by the trustee. A transfer may be an act of bankruptcy even though the creditor had no reasonable cause to believe the debtor insolvent when the transfer was made. Such transfer may be a preference, but it is not voidable. Creditors may retain preferential payments unless they had reasonable cause to believe the debtor insolvent when such payments were made.

If X, a creditor, receives a preferential payment of $800 and thereafter extends credit to the bankrupt in the amount of $500, the trustee may recover from X only $300: X is permitted to set off the amount of the new credit remaining unpaid at the time of the adjudication in bankruptcy. A transfer is not a preference unless it depletes the estate; hence if the creditor furnishes some *present* consideration for the transfer (cash loan secured by mortgage on debtor's fixtures) he will be protected notwithstanding the fact that he was fully aware of the debtor's insolvency. Preference is permissible under the rules of set-off. (X owes the bankrupt, B, $1,000 and B owes X $800. X is permitted to set off B's debt to him, with the result that X owes B $200, X having thereby obtained a preference on his $800 claim against B. Thus banks may set off a bankrupt depositor's balance against loans to the depositor, unless the deposit was made for the express purpose of preferring the bank, in which event the right of set-off is denied, and the amount of the deposit must be turned over to the trustee in bankruptcy as part of the estate.)

LIENS UNDER JUDICIAL PROCEEDINGS

Every lien against the property of B (bankrupt), obtained under judicial proceedings within four months before the filing of a petition in bankruptcy, is void if B was insolvent at the time such lien was obtained, except that liens in favor of employees, contractors, mechanics, and landlords and tax liens may be valid against the trustee in bankruptcy "even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition in bankruptcy."

FRAUDULENT TRANSFER

A transfer of property may be fraudulent because T (transferor) makes it with the *actual* intent to hinder, delay, or defraud his creditors (existing or future). Intent to defraud existing creditors will be *presumed* in law if the transfer was made without fair consideration and if T was insolvent when the transfer was made, or if he was thereby

rendered insolvent: under such circumstances T's actual intent is immaterial. Such fraudulent transfer made within one year before the filing of the petition in bankruptcy is void against the trustee in bankruptcy, except that a bona fide purchaser of the property so transferred will be protected. This rule, of course, in no way limits the right of T's creditors to bring suit to set aside as fraudulent, transfers made more than one year before the filing of a petition in bankruptcy. Such right is determined by the law governing fraudulent conveyances.

PROVABLE DEBTS

Not all classes of debts are entitled to share in the estate. Dividends will be paid only on provable debts, including:

1. Fixed liabilities: judgments, open accounts, contracts expressed or implied. Claims of creditors who have received voidable preferential transfers or payments will not be allowed until the preference has been surrendered, and then the creditor may prove only for the excess of his claim over the preference.

2. Contingent liabilities: contingent debts and contractual liabilities; claims for damages arising out of anticipatory breach of contract, but a lessor's claim for rent under an unexpired lease will not be allowed for more than: (a) the rent reserved for the one year succeeding the date of the surrender of the premises to the landlord or the date of re-entry by the landlord (whichever occurs first), plus (b) the unpaid rent accrued up to such date of surrender or re-entry. Provisions for acceleration are without effect in determining amounts due under (a) and (b).

3. Provable debts reduced to judgment after the filing of the petition and before discharge.

4. Claim for damages based on negligence, where suit was pending when the petition in bankruptcy was filed. Tort claims, in general, are not provable unless liquidated by judgment or settlement before the petition in bankruptcy was filed.

All claims must be filed within six months from the date first fixed for the first meeting of creditors, except that the time for filing tax claims may be extended.

DISCHARGEABLE CLAIMS

A discharge in bankruptcy releases the debtor from all provable claims with certain exceptions among which may be noted:

1. Liabilities based on fraud, embezzlement, misappropriation, or defalcation while acting in a fiduciary capacity; obtaining money or property by false pretenses.

2. Torts involving wilful and malicious injury to person or property (such claim, if reduced to judgment *before* the petition was filed, is provable).

3. Taxes.

4. Alimony, maintenance or support of wife or child, seduction, criminal conversation.

5. Claims not scheduled in time for proof and allowance, unless the creditor had notice or actual knowledge of the bankruptcy proceedings.

6. Wages of the kind entitled to priority (see page 339) earned within three months before the date of commencement of the proceedings in bankruptcy.

7. Money belonging to an employee and deposited with his employer as security for the faithful performance of a contract of employment.

DISCHARGE IN BANKRUPTCY

Unless valid objections are filed, a bankrupt will be granted a discharge from all dischargeable claims listed in his schedules. Valid objections are based on some form of fraudulent commercial behavior (issuing false financial statement for credit purposes, failure to keep records or books of account, the commission of some specific bankruptcy offense). Only one discharge will be granted within a period of six years. The discharge of a partnership does not discharge the individual general partners from liability for the partnership debts.

Part X: Government Regulation of Business

Chapter XLIX

TRADE REGULATION

THE COMMERCE CLAUSE

The power of the Federal Government to regulate business derives from the "commerce" clause of the Constitution, which provides that "The Congress shall have power. . . to regulate commerce with foreign nations, and among the several States, and with the Indian tribes." "Commerce" in the Constitution is said to be a practical concept drawn from the established course of business and meaning intercourse (and all its component parts) for the purpose of trade (including the purchase, sale, and exchange of commodities, the carriage of persons and property, and the transmission of intelligence) and all the instrumentalities whereby it is carried on. The power is exclusive. Under the constitutional grant of power over interstate and foreign commerce it has been held that Congress (being under no limitations other than those found elsewhere in the Constitution) may legislate:

To prevent the disturbance of interstate commerce (by cessation of the movement therein of manufactured products). Such disturbance may be caused by strikes of employees of a manufacturer *not* engaged in interstate commerce; similarly Congress may prevent disturbance of interstate commerce by an integrated system of public utilities wholly within a single state, but supplying electrical energy to interstate railroads, trains, and terminals, to carriers of messages in interstate and foreign commerce, and to federal buildings;

To prohibit the carriage in interstate commerce of goods manufactured therefor by employees whose wages and hours of employment do not conform to standards enacted by Congress;

To provide for the inspection at auction sales of a commodity of which from 81% to 85% was destined for interstate transportation;

To regulate the marketing of intrastate milk which so competes with the handling of interstate milk as to "affect its price structure";

To impose a tax of 19½% on the gross sales of bituminous coal producers not "voluntarily" subscribing for membership under the Act of 1937—apparently on the theory that price-fixing is a fundamental regulatory technique in the social control of industrial enterprise by the government (where conditions curtail the regulative force of competition) although the business is not "affected with a public interest."

Even where Congress has not acted, no state may regulate or burden interstate commerce (as by levying a privilege tax measured by the gross receipts of the taxpayer from his business of marketing fruit shipped from the taxing state to the places of sale in other states and foreign countries, or an income tax on net income derived wholly from interstate commerce; but if the tax were apportioned to activities carried on within the taxing state, it might be sustained). Thus a 2% sales tax to be paid by the seller, imposed by New York City, having power to tax transactions consummated within its limits, may constitutionally apply to a contract for the transfer of title or of possession, within the city, of coal mined in Pennsylvania and carried thence to a terminal in New Jersey and thence to purchasers in the city (since there is no practical likelihood of the tax being used to place interstate commerce at a disadvantage).

Police Power. Where Congress has not acted, a state may under its police power enact local regulations of interstate or foreign commerce in the interest of public health, morals, convenience, or safety. Such regulations may have an incidental (but not a direct) effect on interstate commerce, provided they do not relate to matters which require uniform treatment throughout the nation (in the absence of regulation by Congress, a Pennsylvania state statute regulating the milk industry was held not to constitute a prohibited burden on interstate commerce, because of the comparatively small amount of the state's total milk production which was exported). A statute of state A regulating the shipment of intoxicating liquor into that state may thus apply to one carrying liquor from state B across state A to state C.

Congressional action supersedes state laws on the same

subject, unless the federal regulation is limited. Aspects of the subject not falling within the scope of such limited federal regulation may be controlled by the state unless the federal statute indicates a legislative intent to preempt the entire field or unless a state statute, in its terms or in its administration, is in plain conflict with the act or policy of Congress. (A state statute prohibiting the operation on state highways of any vehicle carrying any other vehicle "above the cab of the carrier vehicle or over the head of the operator of such carrier vehicle" is properly applicable to interstate carriers [as a valid regulation by the state of "size and weight"] since the Federal Motor Carrier Act of 1935 [while conferring on the Interstate Commerce Commission some measure of power in regard to safety regulations] reserved from the regulatory power of the Commission the matter of "sizes and weight of motor vehicles" thereby leaving it to the states to regulate under their police power.)

The power of a state to regulate its internal commerce is exclusive if that internal commerce affects interstate commerce only slightly, indirectly, and remotely. But if such internal commerce has a direct and substantial effect upon interstate commerce, it falls within the constitutional power of Congress under the commerce clause. (Where railroad carriers are engaged in both interstate and intrastate transportation, federal control of intrastate rates has been sustained as being indispensable to effective control of interstate rates; similarly, the Supreme Court held recently that a federal statute giving the Secretary of Agriculture the power to fix minimum prices on milk moving in interstate commerce, impliedly authorizes him to fix prices on competing milk produced and sold entirely within one state.) The constitutionality of the National Labor Relations Act has been upheld as applied to a corporation which manufactured iron and steel products in its factories in Pennsylvania, on the ground that the activities sought to be regulated directly affected interstate commerce although (when separately considered) they might be intrastate in character. The scope of this power must be con-

sidered in the light of our dual system of government, and may not be extended so as to embrace effects upon interstate commerce so indirect and remote that to embrace them, in view of our complex society, would effectually obliterate the distinction between what is national and what is local and create a completely centralized government. The question is necessarily one of degree.

"Flow Theory" (Stream or Flow of Commerce). The Supreme Court sustained the Packers and Stockyards Act on the ground that the stockyards were but a throat through which the current of commerce flowed and that, hence, sales at the stockyards were not merely local transactions: sales effected "a local change of title" but did not "stop the flow." Employing the same metaphor the Court similarly upheld the Grain Futures Act of 1922 regulating transactions on the Chicago Board of Trade.

DUE PROCESS

The power of the Federal Government to regulate business is limited by the "due process" clause (the Fifth Amendment to the Constitution, which provides, in part: "No person shall be . . . deprived of life, liberty, or property, without due process of law"). Similarly, the Fourteenth Amendment to the Constitution limits the regulatory power of the states. Due process may refer to either:

1. Procedural Due Process (which prescribes the essential conditions of a fair hearing); or

2. Substantive Due Process (which defines civil rights to "life, liberty, and property."

Procedural Due Process. The essentials of a fair trial or hearing are these:

1. D must be given *notice* of the nature, time, and place of a proceeding directly affecting his rights; and

2. Have an *opportunity to be heard* in an orderly proceeding adapted to the nature of the case;

3. Before a court or tribunal having *authority to proceed* with respect to persons and subject matter.

ADMINISTRATIVE BOARDS AND COMMISSIONS. Under the common law the courts never lost their jurisdiction to determine the propriety of administrative or official acts, whereas on the continent the executive power was (in theory) autonomous. With the establishment of the I.C.C. (1887) attention centered on the administrative order, by the issuance of which the Commission exercised a power which (under the common law tradition) belonged to the courts—a power, namely, to determine the meaning of vague terms such as "unreasonable," which Congress had written into the basic statute. (Similarly, the Federal Trade Commission Act [1914] does not define "unfair method of competition" or "deceptive acts or practices," but charges the Commission with the duty of giving to these terms a specific content in the light of experience and changing conditions.) Furthermore, the Commission was not bound to follow court procedure and strict rules of evidence, but could conduct its hearing with a certain degree of informality. Both the administrative power and the manner of its exercise were initially challenged as violative of the requirements of "due process." However, it became settled that Congress might lay down policies and establish standards "while leaving to selected instrumentalities the making of subordinate rules within prescribed limits and the determination of the necessity and validity of such provisions." The vast expansion of this field of administrative regulation[1] in response to the pressure of social needs is made possible under our system by adherence to the basic principles that the legislature shall appropriately determine the standards of administrative action, and that in administrative proceedings of a quasi-judicial character the liberty and property of the citizen shall be protected by the rudimentary requirements of fair play. For lack of such standards the N.I.R.A. was declared unconstitutional, the Supreme Court holding that Congress

1 With the enactment of state public utility acts (modeled after the I.C.C. Act) the administrative board or commission became a familiar and increasingly important organ of government (both federal and state). The businessman must not only proceed in accordance with the basic laws of contracts, sales, negotiable instruments, etc., but must comply with all applicable executive orders and administrative regulations, the number and complexity of which become ever more formidable.

could not delegate to the President blanket power to make codes of fair competition for industries. Even the minimum procedural safeguards of due process of law (notice and reasonable opportunity to be heard) were formerly not required in connection with such administrative rule-making as wage fixation for an industry, *either* because such rule-making was deemed legislative rather than judicial, *or* because it was not thought practical to get in the parties interested. Now, however, rate-making is quasi-judicial, and judicial review of the legality of administrative regulations may properly extend to the determination of whether or not administrative findings of essential facts (whereon the regulations are made to rest) are supported by substantial evidence.

Congress may provide that fact findings (of an administrative board), if supported by evidence, shall be conclusive. But this means that such findings must be supported by substantial evidence — evidence acceptable to a reasonable man — evidence that would justify a refusal to direct a verdict, if the trial were to a jury and the conclusion sought to be drawn from it were one of fact for the jury.

Due process also entitles a respondent to judicial review of an administrative decree (whether such decree be "affirmative" or not), but a respondent must exhaust the prescribed administrative remedy before he is in a position to apply to the courts for relief against a threatened injury.

Substantive Due Process. The Supreme Court has held that the due process clause is more than a mere procedural guarantee; that it is also a limitation on the power of Congress to pass laws arbitrarily affecting life, liberty, and property. Similarly, the Fourteenth Amendment (adopted in 1868) has been interpreted by the Court as a substantive limitation on the power of the state legislatures. Several federal and state statutes designed to regulate wages and hours, and to improve social conditions have been declared unconstitutional on the ground that they violated the freedom of contract which the Court held formed an integral part of the "liberty" guaranteed by substantive due process.

Public and Private Business. The state may regulate certain aspects of any business, whether it be "private" or "affected with a public interest." This "police power" to legislate for the protection of public health, safety, and morals embraces:

1. Organizational procedure (incorporation, limited partnership).

2. Operational requirements (sanitary regulations, safety appliances, liability, and unemployment insurance, wages, hours, zoning ordinances, fire and sanitary regulations).

3. Marketing and Advertising (weights, measures, quality standards, containers, false advertising, misbranding).

4. Personal and Professional services (*licensing:* architects, attorneys, auctioneers, aviators, chauffeurs, commission merchants, contractors, doctors, public accountants, etc. Standards are established to protect the public against incompetence and unethical conduct).

The state may not, however, under present conditions compel a blacksmith or a baker to establish uniform reasonable charges, to serve all customers without discrimination, or to continue the operation of certain facilities. On the other hand, neither the butcher nor the baker can exercise the right of eminent domain (can take private property for a public use) or receive a grant-in-aid (public subsidy) or a secondary franchise (right to use public highway for a business purpose). Such restrictions, powers, and privileges are alike the mark of a "quasi-public" enterprise — public utilities, such as telephone, railroad, power, and water companies.

State statutes limiting the profits of theatre ticket brokers or the rates to be charged by private employment agencies, or fixing the price at which gasoline might be sold in the state, or requiring a person to secure a certificate of public convenience or necessity before engaging in the ice business, have in the past been held violative of substantive due process, on the ground that the businesses in question were not "affected with a public interest." However, no satisfactory criteria for differentiating public from private business could be found, and the trend has been to validate price and wage regulation, whether state or national. A number of recent Supreme Court decisions illustrate this trend:

1930. The Court upheld the power of the Secretary of Agriculture under the Packers and Stockyards Act to determine the just and reasonable charges of persons engaged in the business of buying and selling in interstate commerce livestock at a stockyard on a commission basis.

1931. The Court sustained a state statute limiting commissions of agents of fire insurance companies.

1934. The Court upheld a state statute which authorized the fixing of retail prices for milk.

1937. The Court sustained a state statute fixing minimum wages for women and minors.

1937. The Court sustained a state statute fixing maximum warehouse charges for the handling and selling of leaf tobacco.

1939. The power of Congress to authorize the fixing of minimum prices for milk was upheld under the commerce clause.

1940. The Court sustained the price fixing provisions of the Bituminous Coal Act of 1937.

1941. The Court upheld the minimum wage and maximum hour provisions of the Fair Labor Standards Act of 1938.

1941. The Court upheld a state statute limiting the amount of the fee which may be charged by private employment agencies (overruling an earlier decision which had declared a similar state statute to be violative of the due process clause).

Four of these cases involved federal legislation which was sustained under the commerce clause; in others, the Court upheld state statutes regulating prices or wages, not on the ground that a so-called emergency justified the exercise of "police power" or that the particular business was "affected with a public interest," but simply on the theory that a state has sovereign power to determine (reasonably) that any business is subject to control to whatever degree may be required by the public welfare. The rejection of the doctrine

which attempted to distinguish public from private business is implicit in the Court's declaration (in the case which sustained the New York milk control act) that there is no "closed category of businesses affected with a public interest," and that where regulation is proper the *sovereign power can control price as well as all other incidents of the business.*

By implication, this case seems to confer upon the state the power to regulate any business, lock, stock, and barrel, whenever the legislature reasonably determines that circumstances are such as to affect it with a public interest.

The clear recognition that where regulation is proper, it may extend to price as well as to all other incidents of a business, should similarly dispel another (historically) false notion — that "police power" is different from or less than sovereign power. As to whether sovereign power extends to price regulation, there never should have been any question. There were English penal statutes against forestalling, regrating, and engrossing ("cornering" a market or creating a monopoly) and old English statutes regulating prices, wages, weights and measures, even quantity and quality of commodities. In New York and Massachusetts there were early statutes fixing prices, wages, and hours and even limiting profits.

RESTRAINT OF TRADE AT COMMON LAW

Assume that D, the proprietor of a market in Boston, sells his business (including the good will) to P, promising as part of the consideration not to open a similar store within a half mile of his former store for a period of two years. D's promise is enforceable at common law. True, the promise limits competition to some extent and partially restricts D in the exercise of his trade, but agreements in restraint of trade are valid and enforceable (unless the restraint sought to be imposed is *unreasonable*) if merely *incidental* to the accomplishment of a normal and legitimate purpose. A restraint is unreasonable if it:

1. Is greater than is necessary to protect the one for whose benefit it is imposed (a promise by D not to open a

to B for resale on a commission basis, A may establish resale prices (since B is A's agent).

FEDERAL LAWS TO PRESERVE FREE COMPETITION

At common law a contract in unreasonable restraint of trade was illegal only in the sense that it was unenforceable, but the making of such contract was not a criminal offense. The need for more effective sanctions led Congress to pass penal statutes designed to preserve free competition. These statutes have been either general in their application or restricted to particular industries. The general statutes are: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act (collectively referred to as the "Anti-trust Laws"). Statutes regulating particular industries, subjecting them to or (in some cases) excepting them from the general operation of the Anti-trust Laws include:

Interstate Commerce Act (1887). Contains the following anti-monopolistic provisions: competing railroads are not permitted to pool freights or divide earnings except on approval of the Interstate Commerce Commission; a railroad may not acquire an interest in a competing water service carrier; competing carriers may not have interlocking directorates or identical officers except on approval of the I.C.C. On the other hand, consolidations and mergers are permissible, and two or more railroad carriers are permitted, after hearing, to acquire control of another carrier through stock purchase or through purchase or lease of properties. (Similarly, the Motor Carrier Act of 1935 sanctions the consolidation or merger of motor carriers on approval of the I.C.C., and the Civil Aeronautics Act of 1938 permits consolidation or merger of air carriers on approval of the Authority.) Unrestricted competition may not (under certain circumstances) be in the public interest. The *Reed-Bulwinkle Act of 1948,* amending the Interstate Commerce Act, permits railroads, truck lines, and inland waterway carriers to make agreements on rates, provided such agreements are approved by and filed with the Interstate Commerce Commission.

Packers and Stockyards Act (1920). Regulates commerce in livestock and its products.

Federal Alcohol Administration Act (1935). Affects the liquor industry, and deals with unfair trade practices therein.

The Shipping Act of 1916. Permits steamship lines engaged in foreign trade or interstate commerce to fix rates, apportion traffic, and pool their earnings. The Act prohibits certain practices, including the payment of "deferred rebates" to shippers and the use of

"fighting ships." A "deferred rebate" is a refund of a portion of the freight charges paid by a shipper under an agreement that he will use the facilities of a particular carrier for a specified time. A "fighting ship" is a ship used by a company, or a conference of carriers, desiring to put a competitor out of business. The A company, for example, stations a "fighting ship" at B's port at the time B's ship is to sail, offering space at rates so low that B cannot compete.

***Export Trade Act* (1918). Exempts export organizations (combines or co-operative associations) from the application of the Anti-trust Laws. Its purpose is to promote our foreign trade and to enable American exporters to compete with similar combinations of other countries in foreign markets.**

***Bituminous Coal Conservation Act of 1937.* Purpose: to stabilize the soft-coal mining industry in the United States.**

***Capper-Volstead Act* (1922). Permits agricultural marketing agreements, but the Secretary of Agriculture has the power to issue cease and desist orders if (as a result of restraints imposed by such agreements) the price of any farm product rises unduly.**

It was the government's policy in 1933 to raise the purchasing power of farm products to the parity level—the level during the base period 1909 to 1914. Two methods were used to accomplish this end:

1. "Production control" over many basic commodities such as cotton, corn, wheat, tobacco, and rice (see infra: Agricultural Adjustment Acts of 1933, 1938).
2. Voluntary "marketing agreements" between the Secretary of Agriculture and *handlers* of a particular product. Under the Agricultural Marketing Agreement Act of 1937, as amended, the Secretary of Agriculture has the power to issue a marketing order making the terms of a marketing agreement binding on all handlers provided (1) the marketing agreement is signed by the handlers of not less than 50% (by volume) of the product and (2) the issuance of the marketing order is approved by two-thirds of the *growers* (by number or by volume) voting in the referendum.

Civil Aeronautics Act of 1938. Pertaining to air carriers, it permits consolidations, mergers, interlocking directorates, pooling of earnings, and rate fixing agreements, subject to approval by the Civil Aeronautics Board.

(Exemption of Telegraph Company Mergers.) Telegraph company mergers approved by the Federal Communications Commission are exempted from the operation of the anti-trust laws by legislation passed in 1943.

McCarran Act (1945). Provides that after 1948 the insurance business shall be subject to the federal anti-trust laws "to the extent that such business is not regulated by the state law." (Marine insurance companies, however, continue to enjoy the exemption from the anti-trust laws granted to them under the *Merchant Marine Act* of 1920.) Early Supreme Court decisions held that insurance was not "commerce" and therefore not subject to regulation by the federal government. In 1944, however, the Supreme Court held in the South Eastern Underwriters Association case that the fire insurance business as conducted under present conditions is interstate commerce, hence subject to the federal anti-trust laws.

THE ANTI-TRUST LAWS

Sherman Act (1890). The Act forbade (1) contracts, combinations, and conspiracies in restraint of interstate and foreign commerce, and (2) attempts, combinations, and conspiracies to create a monopoly of any part thereof. (The Miller-Tydings Amendment of 1937 excluded from the operation of the Act resale price maintenance contracts as to commodities to be sold in a jurisdiction where such agreements were legal.) Its sanctions were:

1. Civil suit for triple damages by any person injured.

2. Injunction proceedings under direction of Attorney General.

3. Violation punishable by (maximum) penalty: $5,000 fine, one year imprisonment, or both.

4. Forfeiture of property in transit (if such property was the subject of a prohibited agreement or owned by an illegal combination).

These prohibitions, directed to the *results* sought to be accomplished (restraint of trade . . . monopoly), fell short of achieving the purposes of the Act. Not only did the Supreme Court (in 1911) limit its applicability to *unreasonable* restraints as defined by the common law (the "rule of reason," and tend to interpret it narrowly (in the very first case presented under the Act the Court dismissed a bill alleging that defendants had obtained a monopoly of the manufacture of refined sugar in the United States, notwithstanding the fact that the sugar was to be transported and sold in states other than the state of manufacture, on the ground that a monopoly of manufacture could not be reached under the Act); but the decisions of the Court (particularly with respect to mergers and consolidations) were so inconsistent as virtually to destroy certainty. Under the "abuse theory of mergers," mergers were sanctioned if the merged enterprise did not own a very high percentage of the separate plants throughout the nation and did not engage in predatory

practices. So long as these conditions were fulfilled and the merger did not result in nation-wide control, the Court seemingly was indifferent to the fact that the merger might result in the power to fix prices in a particular sales territory. In recent years there have been two decisions which indicate a changed viewpoint. Mr. Justice Learned Hand in the Alcoa case (1945) stressed the fact that the monopoly of a single seller acquired by control of over 90% of the primary ingot production of aluminum must lead to price fixing just as surely as price fixing agreements between competitors, which are illegal per se under the Sherman Act. Similarly in the American Tobacco Company case (1946) the Supreme Court held that the "Big Three" had violated the Sherman Act, saying: "The authorities support the view that the material consideration in determining whether a monopoly exists is not that prices are raised and that competition actually is excluded but that power exists to raise prices or to exclude competition when it is desired to do so." On the other hand in the Columbia Steel case (1948) the Supreme Court refused to enjoin the United States Steel Corporation and its subsidiaries from acquiring the assets of the Consolidated Steel Corporation, the largest independent fabricator of steel on the west coast, on the ground that no "unreasonable restraint" on competition was involved. The Court, however, refused "to prescribe any set of percentage figures by which to measure the reasonableness of a corporation's enlargement of its activities by the purchase of the assets of a competitor." In 1950 Congress prohibited the acquisition of stock or assets "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." (See infra: Clayton Act.)

A trade association which distributes or exchanges price information is known as an open-price association. Such associations were held violative of the Sherman Act in the Hardwood Lumber Association case (1921) and in the Linseed Oil Association case (1923), but in the Maple Flooring and Cement Association cases (1925) the Supreme Court held that, in the absence of proof as to restriction of competition, the dissemination of information by open-price trade associations does not constitute illegal activity.

to B for resale on a commission basis, A may establish resale prices (since B is A's agent).

FEDERAL LAWS TO PRESERVE FREE COMPETITION

At common law a contract in unreasonable restraint of trade was illegal only in the sense that it was unenforceable, but the making of such contract was not a criminal offense. The need for more effective sanctions led Congress to pass penal statutes designed to preserve free competition. These statutes have been either general in their application or restricted to particular industries. The general statutes are: the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act (collectively referred to as the "Anti-trust Laws"). Statutes regulating particular industries, subjecting them to or (in some cases) excepting them from the general operation of the Anti-trust Laws include:

Interstate Commerce Act (1887). Contains the following anti-monopolistic provisions: competing railroads are not permitted to pool freights or divide earnings except on approval of the Interstate Commerce Commission; a railroad may not acquire an interest in a competing water service carrier; competing carriers may not have interlocking directorates or identical officers except on approval of the I.C.C. On the other hand, consolidations and mergers are permissible, and two or more railroad carriers are permitted, after hearing, to acquire control of another carrier through stock purchase or through purchase or lease of properties. (Similarly, the Motor Carrier Act of 1935 sanctions the consolidation or merger of motor carriers on approval of the I.C.C., and the Civil Aeronautics Act of 1938 permits consolidation or merger of air carriers on approval of the Authority.) Unrestricted competition may not (under certain circumstances) be in the public interest. The *Reed-Bulwinkle Act of 1948*, amending the Interstate Commerce Act, permits railroads, truck lines, and inland waterway carriers to make agreements on rates, provided such agreements are approved by and filed with the Interstate Commerce Commission.

Packers and Stockyards Act (1920). Regulates commerce in livestock and its products.

Federal Alcohol Administration Act (1935). Affects the liquor industry, and deals with unfair trade practices therein.

The Shipping Act of 1916. Permits steamship lines engaged in foreign trade or interstate commerce to fix rates, apportion traffic, and pool their earnings. The Act prohibits certain practices, including the payment of "deferred rebates" to shippers and the use of

"fighting ships." A "deferred rebate" is a refund of a portion of the freight charges paid by a shipper under an agreement that he will use the facilities of a particular carrier for a specified time. A "fighting ship" is a ship used by a company, or a conference of carriers, desiring to put a competitor out of business. The A company, for example, stations a "fighting ship" at B's port at the time B's ship is to sail, offering space at rates so low that B cannot compete.

Export Trade Act (1918). **Exempts export organizations (combines or co-operative associations) from the application of the Anti-trust Laws. Its purpose is to promote our foreign trade and to enable American exporters to compete with similar combinations of other countries in foreign markets.**

Bituminous Coal Conservation Act of 1937. **Purpose: to stabilize the soft-coal mining industry in the United States.**

Capper-Volstead Act **(1922). Permits agricultural marketing agreements, but the Secretary of Agriculture has the power to issue cease and desist orders if (as a result of restraints imposed by such agreements) the price of any farm product rises unduly.**

It was the government's policy in 1933 to raise the purchasing power of farm products to the parity level—the level during the base period 1909 to 1914. Two methods were used to accomplish this end:

1. "Production control" over many basic commodities such as cotton, corn, wheat, tobacco, and rice (see infra: Agricultural Adjustment Acts of 1933, 1938).
2. Voluntary "marketing agreements" between the Secretary of Agriculture and *handlers* of a particular product. Under the Agricultural Marketing Agreement Act of 1937, as amended, the Secretary of Agriculture has the power to issue a marketing order making the terms of a marketing agreement binding on all handlers provided (1) the marketing agreement is signed by the handlers of not less than 50% (by volume) of the product and (2) the issuance of the marketing order is approved by two-thirds of the *growers* (by number or by volume) voting in the referendum.

Civil Aeronautics Act of 1938. Pertaining to air carriers, it permits consolidations, mergers, interlocking directorates, pooling of earnings, and rate fixing agreements, subject to approval by the Civil Aeronautics Board.

(Exemption of Telegraph Company Mergers.) Telegraph company mergers approved by the Federal Communications Commission are exempted from the operation of the anti-trust laws by legislation passed in 1943.

McCarran Act (1945). Provides that after 1948 the insurance business shall be subject to the federal anti-trust laws "to the extent that such business is not regulated by the state law." (Marine insurance companies, however, continue to enjoy the exemption from the anti-trust laws granted to them under the *Merchant Marine Act* of 1920.) Early Supreme Court decisions held that insurance was not "commerce" and therefore not subject to regulation by the federal government. In 1944, however, the Supreme Court held in the South Eastern Underwriters Association case that the fire insurance business as conducted under present conditions is interstate commerce, hence subject to the federal anti-trust laws.

THE ANTI-TRUST LAWS

Sherman Act (1890). The Act forbade (1) contracts, combinations, and conspiracies in restraint of interstate and foreign commerce, and (2) attempts, combinations, and conspiracies to create a monopoly of any part thereof. (The Miller-Tydings Amendment of 1937 excluded from the operation of the Act resale price maintenance contracts as to commodities to be sold in a jurisdiction where such agreements were legal.) Its sanctions were:

1. Civil suit for triple damages by any person injured.

2. Injunction proceedings under direction of Attorney General.

3. Violation punishable by (maximum) penalty: $5,000 fine, one year imprisonment, or both.

4. Forfeiture of property in transit (if such property was the subject of a prohibited agreement or owned by an illegal combination).

These prohibitions, directed to the *results* sought to be accomplished (restraint of trade . . . monopoly), fell short of achieving the purposes of the Act. Not only did the Supreme Court (in 1911) limit its applicability to *unreasonable* restraints as defined by the common law (the "rule of reason," and tend to interpret it narrowly (in the very first case presented under the Act the Court dismissed a bill alleging that defendants had obtained a monopoly of the manufacture of refined sugar in the United States, notwithstanding the fact that the sugar was to be transported and sold in states other than the state of manufacture, on the ground that a monopoly of manufacture could not be reached under the Act); but the decisions of the Court (particularly with respect to mergers and consolidations) were so inconsistent as virtually to destroy certainty. Under the "abuse theory of mergers," mergers were sanctioned if the merged enterprise did not own a very high percentage of the separate plants throughout the nation and did not engage in predatory

practices. So long as these conditions were fulfilled and the merger did not result in nation-wide control, the Court seemingly was indifferent to the fact that the merger might result in the power to fix prices in a particular sales territory. In recent years there have been two decisions which indicate a changed viewpoint. Mr. Justice Learned Hand in the Alcoa case (1945) stressed the fact that the monopoly of a single seller acquired by control of over 90% of the primary ingot production of aluminum must lead to price fixing just as surely as price fixing agreements between competitors, which are illegal per se under the Sherman Act. Similarly in the American Tobacco Company case (1946) the Supreme Court held that the "Big Three" had violated the Sherman Act, saying: "The authorities support the view that the material consideration in determining whether a monopoly exists is not that prices are raised and that competition actually is excluded but that power exists to raise prices or to exclude competition when it is desired to do so." On the other hand in the Columbia Steel case (1948) the Supreme Court refused to enjoin the United States Steel Corporation and its subsidiaries from acquiring the assets of the Consolidated Steel Corporation, the largest independent fabricator of steel on the west coast, on the ground that no "unreasonable restraint" on competition was involved. The Court, however, refused "to prescribe any set of percentage figures by which to measure the reasonableness of a corporation's enlargement of its activities by the purchase of the assets of a competitor." In 1950 Congress prohibited the acquisition of stock or assets "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." (See infra: Clayton Act.)

A trade association which distributes or exchanges price information is known as an open-price association. Such associations were held violative of the Sherman Act in the Hardwood Lumber Association case (1921) and in the Linseed Oil Association case (1923), but in the Maple Flooring and Cement Association cases (1925) the Supreme Court held that, in the absence of proof as to restriction of competition, the dissemination of information by open-price trade associations does not constitute illegal activity.

The Supreme Court held in 1951 in the Timken Roller Bearing case that agreements between an American corporation and its British and French subsidiaries violated the Sherman Act where such agreements sought to divide world markets for the sale of antifriction bearings. In the Kiefer-Stewart case (1951) the Court held that a conspiracy to fix maximum prices is illegal per se and violative of the Sherman Act.

Clayton Act (1914). **In this Act Congress proceeded to supplement the prohibitions of the Sherman Act (directed at undesirable *results*) by forbidding specific practices, declaring that it was unlawful:**

1. To discriminate in price between different purchasers. In the Cement Institute case (1948) the Supreme Court held that the multiple basing-point plan in use in the cement industry resulted in price discrimination in violation of the Clayton Act. The Court sustained the finding of the Federal Trade Commission: "(1) that the industry's Institute actively worked, in cooperation with various of its members, to maintain the multiple basing-point delivered price system; (2) that this pricing system is calculated to produce, and has produced, uniform prices and terms of sale throughout the country; and (3) that all of the respondents have sold their cement substantially in accord with the pattern required by the multiple basing-point system."

2. **To lease or sell goods on condition that the lessee or vendee should not use or sell goods of a competitor of the lessor or vendor ("tying clauses" prohibited: S, controlling 95% of the shoe machinery business in the United States, may not require a lessee to buy all supplies from S when the supplies offered for sale by competitors of S are just as** good. However, in the General Motors case (1935) the Supreme Court held that "tying clauses" are not illegal per se, and sanctioned a contract which required Buick and Chevrolet auto distributors to use and sell only new parts authorized by General Motors when such parts were needed for replacement purposes. The Court held that the requirement was appropriate to protect General Motors' good will and that it did not result in a substantial lessening of competition in

the sale of replacement parts. The phrase "substantially lessen competition" was again interpreted in 1948 by the Supreme Court in the Standard Oil Company of California case which involved an exclusive dealing contract. Mr. Justice Frankfurter held such contract invalid if a "substantial portion of commerce is affected."

3. To acquire stock in other corporations.

Any one of these three acts is unlawful provided that it *lessens competition substantially* or *tends to create a monopoly.* Enforcement machinery is similar to that set up under the Sherman Act. The Clayton Act prohibited certain interlocking directorates. It specifically provided that labor and agricultural organizations (cooperatives) should not be held "to be illegal combinations or conspiracies in restraint of trade under the anti-trust laws."

In 1950 the Clayton Act was amended to prevent a corporation from acquiring another corporation through the acquisition of its assets, where, under the present law, it is prohibited from acquiring the stock of said corporation. "Since the acquisition of stock is significant chiefly because it is likely to result in control of the underlying assets, failure to prohibit direct purchase of the same assets has been inconsistent and paradoxical as to the over-all effects of existing law" (Senate Report No. 1775, June 2, 1950). Acquisition of stock or assets is now prohibited "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

The Federal Trade Commission Act (1914). The Sherman Act provided machinery for punishing violations, enjoining their continuance or breaking up existing illegal combinations. The Federal Trade Commission Act created an administrative body (the Federal Trade Commission) "empowered and directed" to prevent the use of "unfair methods of competition" in interstate and foreign commerce. The Act does not attempt to define or enumerate prohibited practices, but leaves the content of the generic term "unfair practice" to be filled in by the Commission in the light of

experience and changing conditions. A "cease and desist" order, issued by the Commission after hearing, becomes "final" within 60 days, if no petition for review is filed in the Circuit Court of Appeals. If an order is reviewed and affirmed by the court, it becomes final at a specified time. In either case, violation of a final order entails a penalty of $5,000 recoverable in a civil action brought by the United States. Under the Wheeler-Lea amendment of 1938, which declared unlawful deceptive acts or practices, the Commission may apply for preliminary injunction to stop false advertising of injurious drugs, food, devices, or cosmetics (advertising of weight reducing product containing a drug that could cause impairment of eyesight enjoined) thus protecting the public pending the final disposition of the case.

Since its establishment in 1914 the Federal Trade Commission has dealt with a wide variety of unfair competitive practices including:

(a) *Unfair Price Practices*: resale price maintenance, below cost selling and rebates, price discrimination (quantity discounts).

(b) *False Advertising*: misbranding, use of misleading names.

(c) *Miscellaneous Unfair Practices*: bribery, espionage, disparagement of goods.

(d) *Restraint of Trade*: stock acquisition by competing company, price fixing, trade boycotts, division of territory.

Resale Price Maintenance. It is not clear how far one may go in establishing resale prices by means of a policy which includes: "suggesting" resale prices, providing for price cutters to be reported either by special agents or by dealers whose assistance is requested, and blacklisting all who fail to abide by the "suggested" price schedule. The mere announcement of such policy may be regarded as implying an illegal agreement in restraint of trade, a situation which has prompted the caustic observation that the law permits one to establish resale prices provided his procedure is casual rather than efficient.

Robinson-Patman Act of 1936. The Clayton Act prohibited price discrimination "where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce" (*sc.*, interstate commerce). The Supreme Court interpreted these words in such manner as to exclude from the operation of

the Clayton Act all price discriminations which had no *general* effect on the market, however much they might affect competition between particular individuals. To cure this defect and to implement and strengthen the price discrimination provisions of the Clayton Act, Congress in 1936 passed the Robinson-Patman Anti-Price-Discrimination Act (amending the Clayton Act, Section 2), which declared it unlawful for a seller to discriminate in price between different purchasers of commodities of like grade and quality (or for the customer knowingly to induce or to receive such discrimination) where the effect might be substantially to lessen competition or tend to create a monopoly or to injure, destroy, or prevent competition with buyer or seller or either's customers. Enforcement machinery includes: cease and desist orders by the Federal Trade Commission, United States Government suit for injunction, private action by any person injured for triple damages, or injunction.

1. **Permissible Differentials in Price.** The Act does not require a seller to maintain a uniform price under all conditions. It permits differentials "which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which commodities are . . . sold or delivered. (However, the Federal Trade Commission may fix quantity limits above which price differentials are prohibited, even though supported by differences in cost. Otherwise, if only a few units in an industry had the power to buy in quantities large enough to take advantage of the lower price, a monopoly could easily develop.)

The Supreme Court held in 1948 that quantity discounts given by the Morton Salt Company were not permissible. The company failed to establish that the lower prices were justified by lower costs or made in good faith to meet the price of a competitor. "Theoretically," said Mr. Justice Black, "these discounts are equally available to all, but functionally they are not." Answering the company's contention that its schedule of quantity discounts had not in fact injured competition, the court said "the statute does not require that the discrimination must in fact have harmed competition, but only that there is a reasonable possibility that they 'may' have such an effect."

Section 2 (b) permits price discrimination in good faith by a seller to meet—but not to undercut—the price of a competitor. In the Standard Oil of Indiana case (1949) 4 large "jobbers" out of 389 small service stations in the Detroit area received lower prices from the Standard Oil Company which defended the discrimination on the ground that it acted in "good faith to meet the lower price of a competitor." The Supreme Court held the defense good (1951).

2. **Specific Prohibited Discriminations.** The seller may not:

(a) Pay or accept commission, brokerage, or other compensation except for services rendered in connection with the sale or purchase of goods (seller, buyer, and broker violate the statute where seller pays broker fees intended for buyer, and such fees are transmitted by broker to buyer).

(b) Pay a customer for services or facilities in connection with processing, handling, or sale of products (advertising allowance) unless such allowance is available on proportionally equal terms to all other customers competing in the distribution of such products.

(c) Favor a customer with respect to furnishing services or facilities in connection with processing, handling, or sale of goods. The seller must furnish proportionally equal facilities and services to all buyers. In *Corn Products Refining Co.* v. *Federal Trade Commission,* 65 Sup. Ct. Rep. 961 (1945), a basing point system of pricing was held violative of the Act.

3. **Permissible Price Changes.** Market conditions may justify price changes. Such conditions are not limited to obsolescence of seasonable goods. Price changes are also permitted with reference to deteriorated perishable goods, goods sold under distress or under court order, or discontinued lines.

4. **Buyer May Be Guilty of Violation.** The criminal provisions of the Act apply not only to the seller, but to all persons who knowingly induce or receive a prohibited discrimination in price.

5. **The Act Permits Refusal to Sell.** The seller is free to sell or not to sell to a given buyer. The discrimination provisions become operative only if there is a sale, or contract to sell.

Patents. Although a patentee enjoys a monopoly within the limits defined by the Patent Laws, the Anti-trust Laws apply to:

1. *Tying Clauses*: sales of patented articles on condition that all accessories be purchased from the seller. (D licenses P to manufacture patented radio receiving sets on condition that P buy exclusively from D unpatented tubes to be initially installed in the sets. The agreement is illegal.)

2. *Patent Pools and Cross-licensing Agreements*. Patentees may pool patents, cross-license one another, and agree on a division of royalties for their joint protection, but not for the purpose of monopolizing a whole field of trade.

3. *Resale Price Maintenance*. Where a patentee grants a *license to manufacture* or assigns the patent he may annex conditions as to resale price which would fall under the ban of the Anti-trust Laws had they been imposed as incident to the *sale* of the patented article.

Fair Trade Acts. Resale price maintenance (held unlawful under the Sherman Act and the Federal Trade Commission Act) was legalized as to intrastate sales in a number of State Fair Trade Acts (beginning with that enacted in California in 1931 and sustained by the Supreme Court[2] of the United States in 1936) now in force in nearly every state in the union. They differ *inter se* as to whether or not (1) non-contracting dealers must conform with established prices, and (2) one other than the owner of the trade-mark or an authorized distributor can establish them, and (3) also as to whether minimum or absolute price agreements are legalized. Their purpose is to protect the owners of trade-marks or names, distributors, and the public generally, by preventing the loss of business values through unfair competition leading to consumer dissatisfaction where "identified" commodities, bearing a distinctive name or mark, are sold or advertised at "cut rates" — to the detriment of the good will created or enlarged by the identifying mark or brand associated with such commodity. The evidence of the statutory violation is thus the use of the trade-mark, brand, or name in accomplishing a disposal of the commodity.

The provisions authorized by the various Acts are not uniform; they may permit agreements:

(a) By the buyer (B) as to B's not selling at less than

---

2 In the Seagram case (299 U. S. 183) the Court sustained Fair Trade Acts as against the attack:

1. That they invaded the due process clause by denying to an owner (through legislative enactment) the right to determine for himself the price at which he would sell property; the Fair Trade Acts do not constitute legislative price fixing but merely legalize the contracts of designated individuals with reference thereto;

2. That there was unlawful delegation of power to private persons to control the disposition of property of others acquired by them without pre-existing restriction as to use or disposition;

3. That they deny equal protection of the laws; the equal protection clause does not preclude resort (for purposes of legislation) to reasonable classification having a fair and substantial relation to the object of the legislation, so that all similarly circumstanced shall be treated alike.

The Court held that the good will (attaching to a brand or trade-mark) is valuable property; that the sale of the commodity is not a sale of the good will; and that, just as the legislature can protect other species of property against injury, so it can protect good will against impairment or destruction by price-cutting.

the minimum resale price (or except at a price) stipulated and as to requiring B's vendee (C) to agree not to resell at less than the stipulated price; and

(b) By the seller (S) to require, upon the sale of such commodity to another (B), that:

1. B agree not to sell under the minimum price stipulated; or

2. That B agree not to sell to any wholesaler (X) unless X agrees not to sell to any retailer (Y) unless Y agrees not to resell except to consumers for use and at not less than the stipulated minimum, or unless X agrees not to sell to any other wholesaler (Z) unless he make corresponding agreements with his vendee; or

3. That B agree not to resell except at the stipulated price.

Sales to close out a commodity in which the seller is ceasing to deal, and sales of damaged or deteriorated goods, are not within these acts. Enforcement of the established price agreements may be either on the theory of contract or on that of statutory liability.

The Miller-Tydings Act of 1937 enacts that nothing in the Sherman Act or the Federal Trade Commission Act shall render illegal (as to interstate transactions where lawful in the state of sale) agreements prescribing minimum price for the resale of a commodity which bears (or whose label or container bears) the trade-mark, brand, or name of the producer or distributor thereof, and which is in free and open competition with commodities of the same general class produced or distributed by others. This, however, expressly does not legalize such price maintenance agreements between manufacturers, or between producers, or between wholesalers, or between brokers, or between factors, or between persons in competition with each other. In 1951 the Supreme Court held in the Schwegmann Brothers case that a retailer who refused to sign a minimum resale price contract could not be enjoined from selling below the minimum price. The Court construed the Miller-Tydings Amendment to the Sherman Act as applicable only to those persons who are parties to fair-trade contracts.

MISCELLANEOUS FEDERAL REGULATION

Since 1937 the Supreme Court (by interpretation of the commerce clause) has approved federal control of wages, hours, prices, and collective bargaining in industries hitherto regarded as local (intrastate). Similarly, the court has sanctioned greatly extended federal control over agriculture. Some of the more recent legislation may be briefly outlined as follows:

Labor Laws.

1. National Labor Relations Act (1935). This statute guarantees the right to collective bargaining. It created the N.L.R.B., with power to stop unfair labor practices of employers, viz:

a. Interference of coercion of employees with reference to their union membership activities.

b. Domination or interference by the formation, administration, or financial support of any labor organization (company unions).

c. Discrimination in regard to hire or tenure of employment for the purpose of encouraging or discouraging union membership.

d. Discharge or other discrimination against any employee who has filed charges or given testimony under the Act.

e. Refusal to bargain collectively with the representatives of employees (the Board has the power to conduct employees' elections, and to determine the appropriate unit for collective bargaining—"employer unit, craft unit, plant unit, or subdivision thereof").

The Act applies to labor disputes which burden or affect interstate commerce, or to situations which might lead to such disputes. The Supreme Court has upheld its constitutionality as applied to: manufacturing industries; a power company producing and selling the major portion of its output in New York State (on the ground that labor trouble

in the plant would affect interstate activities of railroads to which the company furnished power); a business engaged in the manufacture, sale, and delivery of goods in the state of New Jersey (sale and delivery as well as manufacture being consummated in that state), on the ground that the raw materials and finished products of the factory moved in interstate commerce, which reasoning would seem to exclude very few (if any) businesses from the operation of the Act. In *Hill et al.* v. *Florida,* 65 Sup. Ct. Rep. 1564 (1945), a Florida statute requiring the licensing of business agents of labor unions was held violative of the Act because of the injunctive and criminal sanctions which the state statute provided.

2. THE NORRIS-LA GUARDIA ACT OF 1932. This Act provides that federal courts shall not enforce yellow-dog contracts (in which employees agree not to join a union), and, except in cases of fraud or violence, shall not issue injunctions in labor disputes.

3. THE CIVIL LIBERTIES ACT OF 1870 AND THE BYRNES ANTI-STRIKEBREAKER ACT OF 1936 as amended by the Act of June 29, 1938, define as criminal certain practices condemned by the National Labor Relations Act. Thus the Byrnes Act makes it a felony " to transport in interstate or foreign commerce persons to be employed to obstruct or interfere with the right of peaceful picketing during labor controversies" (i.e., strikebreakers).

In April, 1938, twenty-two coal mining corporations of Harlan County, Kentucky, were indicted for alleged violations of the Civil Liberties Act of 1870. The indictment alleged a conspiracy on the part of the defendants to prevent the miners from organizing and the use of threats and violence to that end. The government was unsuccessful in the prosecution of this case, but the Act of 1870 on which the indictment was based is still on the books and may be invoked whenever "two or more persons conspire to injure, oppress, threaten, or intimidate any citizen in the free exercise or enjoyment of any right or privilege secured to him by the Constitution or laws of the United States."

4. THE TAFT-HARTLEY ACT (1947). The Act prohibits: the closed shop; the "checkoff" (deduction of union dues from earnings) unless approved by each individual employee; excessive initiation fees; secondary boycotts; jurisdictional strikes; strikes by federal employees; agreements requiring an employer to discharge an employee when such employee is not in "good standing" in the union, provided such employee continues to pay his dues; expenditures and contributions by trade unions in any national election; interference by unions as well as by employers — interference with employees attempting to exercise their rights under the Act.

The Act permits a union shop only if a majority of the eligible employees vote for it. It restricts the right to strike and requires unions as well as employers to bargain in good faith. Unions must report to the Secretary of Labor on compensation of officers, initiation fees, and operating procedures, and must furnish copies of their constitution and by-laws. They must give to every member periodic financial statements and file such statements with the Labor Department. To be eligible for office all officers of every local or international union must file affidavits that they are not Communists.

In 1951 in the Denver Building and Construction Trades Council case the Supreme Court held that a strike is an unfair labor practice if an object of the strike is to force a general contractor to break a contract with a subcontractor who employs non-union workmen. This decision involved construction of a section of the National Labor Relations Act, as amended by the Taft-Hartley Act, which provides that it is an unfair labor practice for a labor union or its agents "to engage in . . . a strike . . . where an object thereof is (A) forcing or requiring . . . any employer or other person . . . to cease doing business with any other person. . . ."

In 1951 the Supreme Court decided in the Highland Park Company case that the CIO and the AFL are "national or international labor organizations" within the meaning of section 9(h) of the National Labor Relations Act (which section pertains to the filing of non-Communist affidavits by union officials). The Highland Park decision invalidated representation certificates and union-shop authorization certi-

ficates issued by the National Labor Relations Board under its rule that it was unnecessary for the AFL or the CIO to comply with section 9(h) in order for unions affiliated with such organizations to invoke the processes of the National Labor Relations Board. The Officers of the AFL and the CIO had complied with section 9(h) in 1949. The amendment of 1951 (1) validates the elections affected by the Highland Park decision [repeat elections would have cost the Board an amount estimated at over $1,000,000 (House Report No. 1082, 1951)] and (2) dispenses with the necessity for elections to authorize the making of union-shop agreements; but on the petition of 30% or more of the employees in a bargaining unit, the Board must conduct elections to determine whether the union's authority to make a union-shop agreement shall be rescinded.

5. FAIR LABOR STANDARDS ACT OF 1938. The Act establishes basic minimum wage and maximum hours standards for all employees engaged in interstate commerce or in the production of goods for interstate commerce. The Supreme Court in determining the scope of the Act has interpreted "interstate commerce" broadly (it held, in one case, that the Act applied to porters, maintenance employees, elevator operators and night watchmen of an office building of which 58% of the total rental area was tenanted by the executive officers of a company which carried on its manufacturing elsewhere (*Borden* v. *Borella,* 65 Sup. Ct. Rep. 1223 [1945]).

After October 23, 1945, the Act provides for a minimum wage of 40 cents per hour (raised by amendment in 1949 to 75 cents per hour) and a maximum of 40 hours per week. The "wage includes reasonable cost to employer of board, lodging, and other facilities customarily furnished to an employee." Section 7 (a) of the Fair Labor Standards Act provided compensation for overtime "at a rate not less than one and one-half times the regular rate" at which a person is employed. Congress, however, failed to define "regular rate." The 1949 amendment "for the purpose of computing overtime compensation" and determining the "regular rate" excludes:

1. Premium rates for work on Saturdays, Sundays, or holidays where the premium rate is not less than one and one-half the rate for non-overtime on other days.

2. Premium rates for work outside the basic, normal, or regular work day (not more than 8 hours) or work week (not more than 40 hours) where the premium rate is not less than one and one-half times the rate established by contract for like work performed during such work day or work week.

Certain employees are excepted from both the *wage and hour* provisions of the Act, including: all employees of a retail or service establishment (whose total sales by dollar volume are at least 75% retail and 50% intrastate); executive, administrative, or professional employees; local retailing employees; outside salesmen; seamen; farm workers; pilots; others are entirely excepted from the *overtime* provisions, including: employees engaged in the first processing of milk or cream into dairy products; employees of interstate motor carriers, contract motor carriers and private carriers, provided such employees are subject to the jurisdiction of the Interstate Commerce Commission; others are *partially excepted* from the overtime provisions, including: those engaged in the first processing, canning, or packing of perishable or seasonal fruits or vegetables (the exception obtains for a period of no more than 14 weeks); employees in industry determined by the Administrator to be of seasonal nature (this exception obtains for a period of no more than 14 weeks); employees under union contracts conforming with prescribed standards.

The Administrator may issue certificates authorizing the employment of learners, apprentices, messengers, and handicapped workers at wages lower than the applicable minimum.

If *oppressive child labor* is employed in an establishment in the United States within 30 days prior to the removal of any goods produced in such establishment, the shipment of such goods in interstate commerce is prohibited. Oppressive child labor means: (1) as to children under 16: they may never be employed in mining or manufacturing, but children from 14 to 16 may be employed in other occupations if the

Children's Bureau of the Department of Labor finds that such employment has no adverse effect on their schooling or health; (2) as to children between 16 and 18: they may be employed in any occupation unless it has been prohibited by specific order (of the Children's Bureau of the Department of Labor) as hazardous or detrimental to their health; (3) there are no restrictions as to the employment of children over 18 years of age.

The Administrator may approve the recommendations of an *industry committee* establishing (for the particular industry) a minimum wage higher than 30 cents per hour.

Enforcement. Goods produced under conditions which violate the Act may not be shipped in interstate commerce. Penalties for wilful violations of the wage and hour provisions (and other provisions as to records required to be kept) are maximum prison term of 6 months, a $10,000 fine, or both (except in the case of a first offense, which is punishable only by fine). Review of Administrative orders lies to the United States Circuit Court of Appeals or to the United States Court of Appeals for the District of Columbia.

The provisions of the Act may be also enforced by injunction, for which application must be made in the United States District Courts.

6. Social Security Act of 1935 (Unemployment Insurance). Every employer (of eight persons or more) is to pay for each calendar year "an excise tax, with respect to having individuals in his employ" which (after 1937) is 3% of total wages paid by the employer during the calendar year. The proceeds, when collected, are not earmarked, but go into the Treasury of the United States like internal revenue collections generally. If the taxpayer has made contributions to an unemployment fund under a state law (certified by the Social Security Board as satisfying certain minimum criteria), he may credit such contributions against the federal tax. Such credit, however, is not to exceed 90% of the federal tax. In order to obtain the approval of the Social Security Board, the state law must direct that the contributions to the state fund be paid over immediately to

the Secretary of the Treasury of the United States to the credit of the "Unemployment Trust Fund." The Secretary of the Treasury is to invest in government securities any portion of such fund not required in his judgment to meet current withdrawals. He is to pay out of the Fund to any competent state agency such sums as it may requisition from its credit balance.

The Supreme Court has upheld the validity of the Social Security Act of 1935. The tax on wages, said the Court, differed from the processing tax imposed on the processors of farm products under the A.A.A. of 1933, in that:

"(a) The proceeds of the tax in controversy are not earmarked for a special group.

"(b) The unemployment compensation law which is a condition of the credit has had the approval of the state and could not be a law without it.

"(c) The condition is not linked to an irrevocable agreement, for the state at its pleasure may repeal its unemployment law, terminate the credit, and place itself where it was before the credit was accepted.

"(d) The condition is not directed to the attainment of an unlawful end, but to an end, the relief of unemployment, for which nation and state may lawfully co-operate."

Sale of Securities. Under the *Securities Act of 1933,* a prospectus or securities must not be sent through the mails or through other instruments of interstate commerce unless a registration certificate has been filed with the Securities and Exchange Commission. The certificate, copies of which are obtainable by the public, is kept on file in a public reference room. It must be signed by its issuer, by principal executive, financial, and accounting officers, and by a majority of the board of directors, and must contain or be accompanied by the following data:

Capitalization, voting rights, amount of securities outstanding and detailed description thereof;

Amount of funded debt outstanding and to be created by the security which the issuer proposes to offer;

Price at which the security is to be offered; all commissions and expenses paid or to be paid in connection with such sale; any amount paid to a promotor within 2 years before filing the statement, and the consideration furnished for such payment;

A balance sheet as of not more than 90 days before filing of the certificate, and a profit and loss statement for 3 years preceding the filing of such certificate;

Counsel's opinion as to legality of the issue;

Copies of underlying agreements or trust indentures affecting securities to be offered.

If the certificate contains false or misleading statements, or fails to furnish material information, the Securities and Exchange Commission may enjoin the sale of the securities described therein, and civil remedies are available to purchasers against any person who signed it, provided action is started within 2 years after the discovery of the false statement or the omission, but in no event can suit be started more than 3 years after the security was offered to the public. The statue also provides criminal sanctions, and makes the provisions of the federal criminal code in regard to using the mails to defraud applicable to the sale of securities in interstate commerce.

The Securities Exchange Act of 1934 is designed to curb unfair practices in the securities market, by which a pool may manipulate or "rig" the market (by "wash sales" or "matched orders"). It requires corporations whose securities are listed on any national securities exchange to make statements of financial condition available to the public. It creates the Securities and Exchange Commission with supervisory powers over the stock exchanges. It requires the filing of a registration statement and annual reports from which the investing public may obtain information as to the management and financial condition of corporations whose securities are traded in the market. It restricts solicitation of proxies and regulates trading by officers and directors and principal stockholders (i.e., stockholders owning more than 10% of any class of equity security) in the corporation's securities, and requires them to report such transactions.

Similar regulatory powers are conferred on the commission with respect to over-the-counter trading.

The Act seeks to prevent speculative booms by limiting the volume of credit available to brokers (broker's aggregate loans must not exceed 2,000% of his own capital). Similarly, the act fixes minimum margin requirements, and gives to the Federal Reserve Board control over margin accounts. Investment trust companies and investment counselors are subject to SEC regulation under the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Public Utility Holding Company Act of 1935. This Act creates the Federal Power Commission with power to regulate rates of interstate electric power shipments (supplementary legislation in 1938 confers similar power with respect to wholesale rates for natural gas moving in interstate commerce). It authorizes the Securities and Exchange Commission to simplify and integrate holding company systems and to dissolve holding companies above the "second degree." (Assume that A is an operating gas or electric company; that B holds 10% or more of A's voting stock; that C holds 10% or more of B's voting stock; and that D holds 10% or more of C's voting stock. B, then, is a "first degree holding company, and C, a "second degree" holding company. D must be dissolved, unless an exception is made by the SEC.)

In general, a gas and electric holding company is not permitted to control more than one integrated system defined as one or more units of generating plants, transmission lines, and distributing facilities. Such a system may operate as a single interconnected system in an area or region which may embrace more than one state, but an "integrated system" must not be so large that it cannot be efficiently managed or effectively regulated.

Farm Laws. The *Agricultural Adjustment Act of 1933* imposed a tax on processors of farm products, the proceeds to be paid to farmers who reduced their acreage and crops under agreements with the Secretary of Agriculture. The Act was designed to increase the prices of certain farm pro-

ducts by decreasing the quantities produced. The Supreme Court held that the federal government was without power to control farm production; that the tax was but the means to a prohibited end (the regulation of farm production), "(1) that the so-called tax was not a true one, the proceeds being earmarked for the benefit of farmers complying with the prescribed conditions, (2) that there was an attempt to regulate production without the consent of the state in which production was affected, and (3) that the payments to farmers were coupled with coercive contracts, unlawful in their aim and oppressive in their consequences." The decision was by a divided court, a minority taking the view that the objections were untenable.

Subsequently, Congress passed the *Agricultural Adjustment Act of 1938,* designed to establish parity prices for cotton, corn, wheat, tobacco, and rice in furtherance of a stabilization policy, to be effectuated by means of marketing quotas, and granting of loans on stored surpluses. Soil conservation and price parity payments are made through the States; similarly, acreage allotments are administered by state or local agencies. Penalties are provided for the violation of marketing quotas. The Supreme Court upheld this feature of the Act, ruling that quotas (approved by two-thirds of the producers of tobacco) were within the commerce power and that "the statute does not purport to control production. It sets no limit upon the acreage which may be planted or produced and imposes no penalty for the planting and producing of tobacco in excess of the marketing quota. It purports to be solely a regulation of interstate commerce, which it reaches and affects at the throat where tobacco enters the stream of commerce — the marketing warehouse."

By the *Agricultural Adjustment Act of 1949* the Secretary of Agriculture ". . . is authorized and directed to make available through loans, purchases, or other operations, price support to cooperators for any crop of any basic agricultural commodity, if producers have not disapproved marketing quotas for such crop, at a level not in excess of ninety per

centum of the parity price of the commodity nor less than the level provided in subsections (a), (b), and (c) as follows: . . ." The subsections referred to show levels at from 75% to 90% of parity depending on "the supply percentage as of the beginning of the marketing year." The parity formula provided by the Agricultural Act of 1948 is continued but wages paid hired farm labor are to be included in the parity index used to determine parity prices.

Government Competition.

1. FEDERAL GOVERNMENT. Although the Federal Government may undertake economic activities as an incident to powers specifically enumerated in the Constitution (road building, establishment of the Federal Reserve System, ownership and operation of the Government Printing Office and of public buildings), the Constitution does not confer upon the United States the power to engage in business. However, Article IV, Section 3 provides in part that: "The Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States." Under this clause the Supreme Court in 1935 held that Congress has authority to dispose of electric energy generated at the Wilson Dam (at the Muscle Shoals plant), including not merely the surplus necessarily created in the course of making munitions of war or operating the works for navigation purposes, but the remainder of the available energy which would otherwise be lost or wasted. Noting that Congress, following the discovery of gold in California in 1848, reserved mineral lands for special disposal, the Court asked: "Can it be doubted that Congress could have provided directly for mining by its own agents, instead of giving that right to lessees on the payment of royalties?"

The Government may dispose of its property by any appropriate method adopted in the public interest, provided it is consistent with the "foundation principles of our dual system of government." Accordingly, the Supreme Court held in 1939 that the competition of the Tennessee Valley Authority in underselling certain electric power companies and in

fixing resale rates by contract, does not amount to regulation of their rates in violation of the Tenth Amendment. Moreover, the Court held that co-operative activities of two federal officials did not spell conspiracy to injure the business of the privately owned companies, although one official acted under a statute providing funds for the erection of municipal plants, and the other under a statute authorizing the production of electricity and its sale to such plants in competition with the privately owned companies.

2. The States. Unlike the Federal Government, a state may engage in private business where such activity is reasonably determined to be in the public interest. The Supreme Court of the United States has sustained as valid, taxes levied by a state to establish and maintain a public yard for the sale of wood, coal, and other fuel, without financial profit, to the inhabitants of a municipality; a taxation program and bond issues designed to finance a project whereby a state manufactures and markets farm products, provides homes for the people, and creates a state banking system. In each of these cases the tax was held to be for a "public" as distinguished from a "private purpose," hence not violative of the Fourteenth Amendment. Since the Court held in sustaining the New York Milk Control Act that "there is no closed category of businesses affected with a public interest," it would seem that the legislature might reasonably determine that it was in the public interest for a state to engage in almost any business. In 1927 the Supreme Court upheld the right of a city to sell gasoline and oil to its inhabitants in competition with a private company.

Reciprocal Trade Agreements. On June 20, 1945, the law governing reciprocal trade agreements was extended for a period of three years. It gives the president authority, in negotiating trade agreements with other nations, to reduce tariffs in effect on January 1, 1945, by as much as 50%.

National Defense. The Defense Production Act of 1950, to facilitate effectuation of United States policy of opposing acts of aggression, gives the President extensive regula-

tory powers with respect to: priorities and allocations, requisitioning, expansion of productive capacity and supply, price and wage stabilization, settlement of labor disputes, and control of consumer and real estate credit. In 1951 the Act was amended and extended to June 30, 1952.

Index

COLLEGE OUTLINES and EVERYDAY HANDBOOKS* *(Cont.)*

published by Barnes & Noble, Inc., 105 Fifth Ave., New York 3, N. Y.

College Outlines (CO) and Everyday Handbooks (EH) provide summaries of important academic subjects and instruction in popular activities. They are authoritative, economical books for the student or layman who wishes to learn or to review a subject or an activity quickly. (Prices range from $.50 to $2.50.)

LITERATURE

AMERICAN LITERATURE (CO)
ENGLISH LITERATURE, Dictionary of (EH)
ENGLISH LITERATURE to Dryden (CO)
ENGLISH LITERATURE since Milton (CO)
NOVELS, Plot Outlines of 100 (EH)
WORLD LITERATURE, 2 vols. (CO)

MATHEMATICS, ENGINEERING

ALGEBRA, College (CO)
CALCULUS (CO)
ENGINEERING DRAWING (CO)
GEOMETRY, Analytic (CO)
GEOMETRY, Analytic: Problems (CO)
GEOMETRY, Descriptive (CO)
GEOMETRY, Plane: Problems (CO)
LOGARITHMIC & Trigonometric Tables (CO)
MATHEMATICS For Everyday Use (EH)
MATHEMATICS, COLLEGE (CO)
SLIDE RULE (EH)
TRIGONOMETRY, Plane & Spherical (CO)

PHILOSOPHY

PHILOSOPHERS, TEACHINGS of Great (EH)
PHILOSOPHY: An Introduction (CO)
PHILOSOPHY, Handbook in History of (CO)
PHILOSOPHY, Readings in (CO)
RELIGIONS of the World (EH)

PSYCHOLOGY

PSYCHOLOGISTS, Teachings of Great (EH)
PSYCHOLOGY, CHILD (CO)
PSYCHOLOGY, EDUCATIONAL (CO)
PSYCHOLOGY, GENERAL (CO)
PSYCHOLOGY, READINGS (CO)

SCIENCE

ANATOMY and PHYSIOLOGY (CO)
BACTERIOLOGY (CO)
BIOLOGY (CO)

SCIENCE (Cont.)

BOTANY (CO)
CHEMISTRY, First-Year College (CO)
CHEMISTRY, Organic (CO)
CHEMISTRY, Physical (CO)
CHEMISTRY PROBLEMS (CO)
FOOD and YOU (EH)
GEOLOGY (CO)
PHYSICS (CO)
PHYSICS PROBLEMS (CO)
PHYSICS Without Mathematics (CO)
PHYSIOLOGY, Fundamentals of (EH)
ROCKS and MINERALS (EH)
ZOOLOGY (CO)

SOCIOLOGY, ANTHROPOLOGY

ANTHROPOLOGY, GENERAL (CO)
MAN and SOCIETY (EH)
SEX and MARRIAGE (EH)
SOCIOLOGY, Principles of (CO)
SOCIOLOGY, Readings in (CO)

SOCIAL ACTIVITIES, SPORTS

BRIDGE, First Book of (EH)
CHECKERS, How to Play (EH)
CHESS, First Book of (EH)
CHESS GAMES, How to Win Quickly (EH)
CHESS, Improving Your (EH)
CHESS OPENINGS, Complete Book of (EH
CLUB MEMBER'S Handbook (EH)
DANCE, HOW TO (EH)
FISHING, SPIN- (EH)
FISHING, Sportsman's Digest of (EH)
FOLK DANCES For All (EH)
HUNTING, Sportsman's Digest of (EH)
MANNERS FOR MILLIONS (EH)
PARTY GAMES For All (EH)

STUDY AIDS

EXAMINATIONS in COLLEGE (CO)
HANDWRITING, BETTER (EH)
RESEARCH and REPORT WRITING (CO)
STUDY, BEST METHODS of (CO)
WRITING TERM PAPERS and REPORTS (CO)

**This list begins at the front of the book.*

BUSINESS LAW

COLLEGE OUTLINE SERIES

College Outlines are up-to-date digests of important subjects. They are widely used in colleges, in adult classes, and by individual adults who wish to study the essentials of any field of knowledge. The authors of the Series are well-known scholars who have devoted many years of study and teaching to their subjects. Most of them are full professors, associate professors, or assistant professors, and four out of every five have received their doctorate degrees or the equivalent.

Typical Comments:

"Always good for a readable, understandable exposition of any of the fields that they cover are the books in the College Outline Series."

Dr. Kenneth J. Hansen, *Colorado State College of Education*

"Almost any serious-minded reader finds something in the College Outline Series he wants. This is true of the college graduate no less than the man or woman who has never gone beyond high school."

(Mrs.) Paul Elder, *Paul Elder Bookstore, San Francisco*

"The most useful, inexpensive, and handy reference on my desk."

E. G. McGrath, *Sacramento Senior High School, California*

"Without a doubt the College Outline Series is just what the student needs for review and for gaining a perspective of his particular subject."

Merl F. Renz,
Committee on Standards in English, Purdue University

"These manuals fill a real need; they winnow fundamental principles from a mass of material, give with incisive clarity the contours of the ground already covered and leave with the reader a definite framework which later he may fill in by practical contact with the subject in real life."

Dr. Justin H. Moore,
Professor of Law, College of the City of New York